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CREDIT AVAILABILITY

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC, APRIL 29, 1993

Printed for the use of the Committee on Small Business

Serial No. 103–44

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COMMITTEE ON SMALL BUSINESS

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THURSDAY, APRIL 29, 1993

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order.

Today, our Small Business Committee continues its long-standing inquiry into the causes of the credit crunch, its implications for small business and the broader economy, and possible policy changes that could ensure the flow of credit to this Nation's smaller firms.

There has been an important development regarding credit availability that I have been gratified to see. On March 10, President Clinton announced a credit crunch initiative designed to jump start a renewed flow of credit to small businesses.

In doing so, the President emphasized something that members of this committee have long known. It is our small business sector that has increasingly become the engine of our economy, providing the innovation and job growth on which a growth economy can be built. As the President himself noted, if you had to put in one sentence why this has been a jobless recovery, it is because small business job creation has not offset big business job losses. That must change if our goal of achieving a real recovery that provides real opportunity is to be met.

The regulators are now engaged in the implementation of the President's initiative and review of current law to determine whether additional statutory change is required. It is important that we monitor that process closely to ensure that the desired impact is achieved.

At the time the President's program was unveiled, an administration spokesperson indicated the initiative could mean that up to $46 billion in additional lending would be made by sound institutions. That would be an enormous achievement. But our expectations must be realistic if we are to develop sound policy in this area.

It is my understanding that banks could also simply reclassify character loans already on their books into the pools that they are now authorized to create. If so, that could mean little or no new lending.

I would hope the regulators could provide us with some insight into their realistic expectations regarding the President's program; how it will be monitored to ensure that real new lending results; and what further changes are anticipated, either administratively or legislatively.

I am also cognizant, too, that we must be concerned with striking the appropriate balance between economic stimulation and safe and sound banking practices, too. Of course, I want to make sure that all this economic stimulation that we are attempting to achieve is only done in a safe and sound manner. I appreciate your comments on that.

Now while President Clinton's initiative is important, it is only a small part of what we must do. A key component of the economic stimulus package that failed to pass in the Senate last week was a supplemental appropriation for the Small Business Administration's 7(a) Loan Guarantee Program. Because it did not pass, the SBA loan guarantee window is now closed, and it will remain closed unless and until additional funds are appropriated in another measure.

There was $141 million in that economic stimulation program which would have been used to leverage $2.6 billion in loan guarantee authority. As of this past Monday, no SBA office in the country can give any loan guarantee whatsoever because the cupboard is bare.

That program has been the safety valve for small businesses during the credit crunch. As other sources of funding have effectively dried up for even the most creditworthy small firms, the SBA Program—which grew by 40 percent last year—has taken up the slack. If it is not available to do so, we risk stalling the economic recovery we have worked so hard to begin.

As important as the President's initiative may be, it will take some time for it to have any real impact, and it is no substitute for the program that is really doing the job now.

In the longer term, we must develop new and innovative mechanisms for financing small business. Even before the credit crunch, small businesses had a very difficult time getting the longer term, fixed-rate financing that is so important for their health and growth, or even getting long-rate variable financing. That need remains largely unmet. As important as the SBA loan guarantee program is, we can never realistically expect to expand it sufficiently to meet the full demand.

Sources of long-term capital do exist amongst our institutional investors, but there is no mechanism for making the link between those investors and the small business community. We can help make that link by expanding the secondary market in small business loans, and I would hope to work closely with the administration and the regulators in that effort.

Finally—and this is a very technical issue but I think it is an important one—I would urge the regulators to look more closely at the risk-weightings under the Basle capital standards to determine if, in fact, they create a disincentive to small business lending.

The administration is committed to community development initiatives. Community development requires small business development. Yet financial institutions are predisposed toward the kinds

of investments—Government securities and housing lending—that require the holding of less capital. In fact, our banks are increasingly buying Government securities rather than making productive investments. I would hope we could consider exempting certain small institutions from the Basle standards or at least allowing a lower risk weighting for a portion of a bank's small business portfolio that is clearly directed toward community development. I would appreciate your comments on this issue.

[Chairman LaFalce's statement may be found in the appendix.]

Today, we are very pleased to have with us Mr. Eugene Ludwig, Comptroller of the Currency; Mr. Andrew Hove, the Acting Director of the FDIC; and Mr. Jonathan Fiechter, Director of the Office of Thrift Supervision.

Mr. Hove and Mr. Fiechter have appeared before Congress many times in the past. I understand that this is your first opportunity to testify before the Congress, Mr. Ludwig. I am delighted that opportunity comes before the Small Business Committee. We are especially pleased to have you with us today and hope you will find it a pleasant and worthwhile experience.

I turn to our very distinguished ranking minority member who is extremely interested in all these issues also, Ms. Jan Meyers of Kansas.

Mrs. MEYERS. Thank you, Mr. Chairman. I appreciate this opportunity to hear what progress the Federal banking regulators are making in their efforts to improve credit availability for the Nation's small businesses.

Let me state from the outset that I support strongly safety and soundness regulation for the banking industry. I also feel that our efforts to prevent losses have resulted in a number of conflicting and duplicative regulations.

I am certain that many of these regulations have forced bankers to spend more time worrying about regulators than about banking and that they cause widespread fear of small business lending. An excellent example of this is the banker in Texas who was forced to hire a compliance officer rather than a loan officer due to the regulatory burdens imposed on his institution.

I do not believe that all the problems of credit availability for small business can be laid at the door of the regulatory agencies at all, but I do believe that regulation has created obstacles to effective lending. With that in mind, I support the President's efforts to reduce the regulatory burdens which impair the ability of this Nation's banks to make credit available to small businesses.

I might add that I, too, am very supportive of the 7(a) loan guarantee funding, and I think there are a number of initiatives that are going on. I am introducing a bill today with a number of people on both sides of the aisle.

Since that full appropriation bill in Commerce/State/Judiciary is $23 billion, it seems to me as if we ought to be able to find $141 million and pay for it so that it is acceptable to the Senate and get it moving in a supplementary bill or by unanimous consent or by some other device so that we keep the 7(a) loan guarantee funding available. I think people on both sides of the aisle are very concerned about it.

I do look forward to your testimony, gentlemen. Thank you very much.

[Mrs. Meyers' statement may be found in the appendix.]

Chairman LaFalce. Do any other members of the committee have any opening statements they wish to make?

Mr. Flake.

Mr. Flake. Thank you very much.

Good morning, Mr. Chairman and members of the committee. I would like to thank, first of all, the chairman for holding what I consider to be a very important hearing.

As you know, the Committee on Oversight and Investigation, which I chair, has had hearings involving various entities of the banking community as well as the Federal Home Loan Bank Board.

It has become clear that our small business sector is suffering. Small businesses must be able to have access to credit if they are to participate in stimulating our economy so that we can employ those workers who are either unemployed or displaced. The present lending environment is not adequately meeting these needs. In turn, the economy cannot get its jump start; jobs cannot be created; and many communities are suffering.

While small businesses employ nearly two-thirds of our work force, we cannot abandon the necessary efforts to allow creditworthy borrowers the opportunity to thrive. It is my hope that President Clinton's proposals to reduce some unnecessary and onerous regulatory burdens will work to ensure that banks return to their original role as lenders.

In 1991 and 1992, bank lending to businesses decreased by $36 billion. One need not look far to find out why the economy is in its present condition.

It is my hope that, as we hear the testimony of those who come before us this morning, we will be able to move toward assuring that all businesses, including those owned by socially and economically disadvantaged individuals, will have opportunities to succeed. Toward that end, I look forward to hearing the testimony of our witnesses and having the opportunity to delve further into the President's proposal. I also await the suggestions of our witnesses for moving this economy toward stability.

Thank you very much, Mr. Chairman. I yield back.

[Mr. Flake's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Flake.

Mr. Zeliff.

Mr. Zeliff. Thank you, Mr. Chairman.

I would like unanimous consent to insert my entire statement into the record.

Chairman LaFalce. Without objection, so ordered.

Mr. Zeliff. I just wanted to briefly give a quick overview because I am very anxious to hear the testimony.

I am a small businessman from New Hampshire. New Hampshire has gone through some real tough times. We started out in the mid-1980's as being one of the fastest-growing States in the country, probably the fastest-growing State in the eastern half of the United States, and we had a total breakdown, of our economy

and the banking system. Five out of seven of our top banks went down.

We are now starting to recover. Nobody is looking for a free lunch. I think we want to work our way back. I had seven of my colleagues in Manchester, New Hampshire, looking at areas that we can improve to create jobs. Consistently, the biggest problem comes back to encouraging lending to small business, overregulation, or maybe overzealousness on the part of some regulators.

We had a hearing about a month and a half ago and had subsequent meetings with FDIC.

We can support programs like the New England Lending and Recovery Act, which this committee initiated and started as a pilot program in New Hampshire, and certainly we can support programs of full funding to the 7(a) Lending Program. We need to get lending back to small businesses that are qualified borrowers. This is just not happening.

In this country, 82 percent of the jobs are created by small business. Certainly in New Hampshire, mom and pop businesses are indicative of this. I applaud President Clinton's initiative on character lending. But the bottom line is that it is a risky business. We are going to have to recognize that FDICIA needs to be revisited. I look forward to hearing your comments on that subject.

We have gotten to the point where we are overmanaging and micromanaging banking by putting scare tactics into implementation. Maybe we have overimplemented some of the laws that Congress has made. I think we need to address that as well.

I am looking forward to the testimony, particularly to see if there is any improvements since our previous meetings of a month and a half ago. But I think that we have to somehow address the credit needs of small business or else we are never going to be able to create jobs. That is the big challenge for all of us.

[Mr. Zeliff's statement may be found in the appendix.]

Chairman LaFalce. Are there other Members who would like to make brief opening statements before we get to the witnesses?

Mr. Klink.

Mr. Klink. Mr. Chairman, first of all, I want to apologize. This is one of those typical days in Congress. We are doing RTC markup and pension benefit guarantee corporation all in the same day. So, if we are able to settle all these problems today we can go home this weekend.

Chairman LaFalce. I know the RTC markup is in Banking. Where is pension benefit guarantee corporation?

Mr. Klink. That is in Labor.

Chairman LaFalce. Are you on three committees?

Mr. Klink. Yes; glutton for punishment.

I just want to say I am pleased you are holding this hearing of the Small Business Committee. Solving the credit crunch is, obviously, of importance to the small business community. There is, apparently, a correlation with the increase of small business failures and the lack of reasons that are being offered to them. Even established companies aiming to expand are finding it difficult now to obtain loans. We found that out as we have held some other hearings on the subject.

The question has to be asked, though, are the banks becoming providers of credit to the Federal Government, that is, investing in T-bills instead of making business loans? If so, why?

In a recent hearing on the subject, Chairman Paul Kanjorski, of the Economic Growth and Credit Formation Subcommittee of the House Banking Committee, had some interesting statistics, and I would like to share them with you today. He said the bank deposits have grown by 35 to 40 percent since 1984, yet commercial loans, as a percentage of those assets or deposits, have gone down by 30 percent.

At the same time, the chairman pointed out that purchases of investment grade securities, Federal, State, local, and GSE securities, have increased 97 percent for $373 billion, and commercial and industrial lending is only $219 billion.

Small businesses have been shown to be the greatest source of job creation. I agree with the chairman, they are the engine that runs the economy. Because of this, the resources for small businesses should be made readily available.

I have been in constant communication with bankers in my district. They have discussed their desire to lend more often to small- and medium-sized businesses. They all agree that regulations have restricted their ability to make these loans.

I find it ironic that banks are willing to lend, businesses are willing to borrow, interest rates are low, but deals are not being made that would create jobs. Has the Government, in trying to protect the public from the irresponsible segments of the banking arena, gone too far? Has this had a negative impact on the essential practices of responsible lending and borrowing?

The initiatives set forth by President Clinton show his intent to relax the regulations on small businesses. Such changes include the encouraging of banks to make more character loans, as the chairman mentioned, the allowance of additional types of collateral, and reducing the amount of unnecessary paperwork. The solutions to solving the credit crunch are within reach, I believe, hopefully, with the recommendations of the financial regulating agencies and the gentlemen who are here today.

So, again, I thank you. I apologize for having to pop in and out, but I hope that you will help us get to the bottom of this. Thank you.

Chairman LaFalce. Any other Members who wish to make a brief opening statement?

Mr. Collins.

Mr. Collins. Thank you, Mr. Chairman.

Mr. Chairman, I do not have a prepared statement, but I would like the opportunity to revise and extend my remarks.

Chairman LaFalce. So ordered.

Mr. Collins. Mr. Chairman, I appreciate you conducting this hearing. I receive constant remarks and complaints from my bankers back home that bank regulators react to regulations far greater than they should. I appreciate the President, on March 10, coming out with a program and a plan to change some of those regulations and maybe change the attitude of some of the regulators.

However, simplifying regulations is not the only thing that motivates small businesses to apply for loans. It takes a strong growing

economy; a need for investment capital. I would rather see a strong economy that calls for a need for capital to invest or reinvest, not a demand for loans for operating capital in an attempt just to hang on. But I am afraid that, too, is one of the positions that small business is in today.

On February 17, the President addressed the Congress and the Nation. He outlined in detail a plan that calls for increased taxation, increased taxation that I think will have a direct negative impact on small businesses as well as large businesses. Higher taxes will have a negative impact on employment and a need for capital for investment.

Following that, the President introduced a spending bill, a "stimulus" spending bill that I opposed. Had it passed, it would have had a negative impact on small businesses as well.

True job creation comes from a strong economy and measures that need to be implemented and changed in the Tax Code. We need incentives for incremental development so that there will be a need for loans for investment. We need incentives such as an investment tax credit as we had before, a capital gains tax credit on tangible items, an elimination of the alternative minimum tax, a change in the passive loss rules dealing with real estate values and the allowance of deductions for IRA's to encourage savings. These measures are real, true, job-creating measures. I believe these measures would bring needed applicants into banks where they would apply for loans for the right reasons; capital for investing.

Mr. Chairman, I appreciate your conducting this hearing. I look forward to the testimony.

Chairman LaFalce. Thank you.

Since no other Members have any opening statements they wish to make, we can now turn to the witnesses. I advise the witnesses today that we will put the entirety of your testimony in the record, as if it were read. Therefore, you may feel free to either read that testimony or summarize it, whichever would take less time.

Our first witness will be Mr. Ludwig.

TESTIMONY OF EUGENE A. LUDWIG, COMPTROLLER OF THE CURRENCY

Mr. Ludwig. Mr. Chairman, members of the committee, I appreciate this chance to discuss credit availability for small businesses and the steps that President Clinton and the OCC are taking to encourage bank lending. I have a written statement that I would like to submit for the record. I will briefly summarize that statement this morning.

As the supervisor of national banks, the OCC is committed to insuring that credit is made available in a safe and sound manner to creditworthy borrowers. I am particularly concerned about credit availability for small businesses, farms, minority borrowers, and for low- and moderate-income customers, those segments of the population who have suffered most during the recent credit crunch.

Over the past 2 years national bank lending has declined $85 billion or 6.7 percent. Industry surveys show that small businesses have had more trouble getting loans than larger borrowers. Bank supervision is only one of several factors that have affected the

volume of bank lending, and it may not be the most significant factor. Nonetheless, it has clearly had an impact. In response to higher levels of problem loans, bank supervisors increased their criticism of loans and required larger reserves. The Federal Government established new laws and regulations to reduce risk in the banking system and protect the Federal deposit insurance fund.

The President's program is designed to counter the adverse impact of these actions on lending to creditworthy customers, particularly small businesses and minorities. We want to ensure that regulators do not overreact to past problems and that bankers are not inadvertently discouraged from making good loans.

The President's program lays out five sets of initiatives designed to eliminate regulatory impediments to sound bank loans, while at the same time continuing to ensure a safe and sound banking system.

The first area focuses on reducing the cost and time required to make loans to small- and medium-sized businesses and farms. On March 30, the OCC and the other bank and thrift regulatory agencies released an interagency policy statement that eliminated unnecessary documentation requirements for such loans. Under the new guidelines, well-managed banks with good capital can make some business and farm loans with only minimal documentation. The maximum size of such loans is $900,000 or 3 percent of a bank's total capital, whichever is less. The total volume of these loans can be up to 20 percent of a bank's capital.

The second area of the President's program deals with regulatory requirements for appraisals and other aspects of real estate lending. Because small businesses generally have few tangible assets, their owners often secure their loans with mortgages on their houses or places of business even though the source of repayment is the cash-flow from the business. Current regulations require a formal real estate appraisal if the amount of the loan is more than $100,000, a requirement that may make such loans too expensive for some small borrowers. Accordingly, we are considering ways to reduce this burden that will not increase the risk of problems from real estate loans that caused major credit losses in the past.

Under the third part of the President's program, the OCC will take steps to make sure its appeals process is fair and effective. To achieve that goal, I am creating a position for a senior official who will report directly to me, with sole responsibility for overseeing the OCC's appeals process. Bankers and bank examiners alike will benefit from the knowledge that appeals of examination results will be reviewed and decided in an entirely impartial manner. We are also reviewing our consumer complaint process to improve the care and timeliness of our responses.

The fourth area of the President's program takes aim at the costs imposed by examinations on regulated financial institutions. The agencies are working to reduce these costs by eliminating duplication and increasing coordination in their examinations.

Finally, all the agencies are continuing their efforts to improve examinations and reduce unnecessary regulatory burden. At the OCC, we intend to review every regulation from A to Z. We want to eliminate unnecessary and duplicative rules, and we want to put them in plain English so they are accessible to everyone. We think

this will result in a real reduction in burden, without in any way reducing the safety and soundness of the system or compromising equal credit opportunity.

Mr. Chairman, this stack of books represents most of the regulations that apply to national banks. It is a pretty big stack. Our goal is to reduce this stack to something approaching this single volume.

As an example, in CRA, we want to focus more on results and less on paperwork and process. We want to emphasize improving credit availability to small businesses in low- and moderate-income neighborhoods. These measures are part of the administration's broader effort to ensure equal credit opportunity for all Americans, a goal to which I am personally and deeply committed.

Bank supervision is not the only cause of the credit crunch, but it has undoubtedly added to the cost of lending and to some extent reduced the supply of bank credit. The actions I have outlined will, I believe, begin to address the problem. They will improve the flow of credit, particularly to creditworthy borrowers who have been denied loans in the past, whether because of illegal discrimination or because of unnecessary regulation.

The relationship of OCC and national banks is symbiotic. Banks and regulators have a shared interest in having a safe and sound banking industry. When we identify problems, bankers know we will take the necessary action to solve them.

But that does not mean that we should seek a banking system that is entirely risk-free. Lending, by its nature, involves an element of risk. A risk-free banking system would not meet the credit needs of its customers or, indeed, the needs of the economy.

The genius of the President's program is that it encourages banks to be banks. It encourages them to make loans to the fullest extent possible, consistent with safety, soundness, and with the principles of fair lending.

The impact is in the details of the program. These details are not dramatic in and of themselves. Reviewing regulations doesn't make for good sound bites on the evening news, but I am convinced that this approach will do more to help make credit available than other approaches that involve sweeping changes or mere jawboning.

Commercial lending is a cornerstone of a strong banking system and a growing economy. The President's program strikes the necessary balance between expanding credit availability and preserving the safety and soundness of the banking system.

Mr. Chairman, I appreciate this opportunity to address these important issues. I will be happy to answer any questions that you or your colleagues may have. Thank you.

Chairman LaFalce. Thank you, Mr. Ludwig. We will refrain from asking questions until all the witnesses have made their presentations.

[Mr. Ludwig's statement may be found in the appendix.]

Chairman LaFalce. Our next witness, the Acting Chairman of the FDIC, Mr. Andrew "Skip" Hove.

TESTIMONY OF ANDREW C. HOVE, ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. HOVE. Thank you, Mr. Chairman, and members of the committee. I am pleased to have this opportunity to give the views of the Federal Deposit Insurance Corporation on credit availability for small businesses.

Small- and medium-sized businesses are the engines of job growth in our economy. Because they generally have very limited or no access to public credit markets, it is critically important that these businesses have adequate access to bank credit.

I have submitted for the record a detailed written statement discussing credit availability, the FDIC's active participation in a program of regulatory and administrative changes to stimulate bank lending to small businesses, and other related issues. In the interest of time this morning, I will touch upon a few of the important points rather than read our entire written statement.

You might ask, why is there a credit availability problem? In many respects, the problem may be described as the still-pounding hangover from the excesses in bank lending in the 1980's. Banks get in trouble and fail primarily, though not exclusively, from making bad loans, and a bad loan is simply a loan that is not repaid.

With total assets of $63 billion, 124 banks failed in 1991, and 120 banks with assets of more than $44 billion failed in 1992. Over the last 5 years, more than 800 banks with total assets approaching $200 billion have failed. In the last 10 years, something in the neighborhood of 1,400 banks, with total assets of around $220 billion, have failed. By number of institutions, that is about one-tenth of our banking industry as it stood 10 years ago. Again, most of those failures, representing almost $200 billion in assets, occurred in the last 5 years.

In the aftermath of the excesses and losses in recent years, banks generally strengthened their underwriting standards. Many banks are continuing to work off troubled assets. Consequently, they are more selective and more hesitant to finance new businesses or the expansion of established businesses without a substantial commitment of equity from the borrower, and a demonstrated record of repayment.

Borrowers who cannot meet the more selective criteria are having a particularly difficult time in obtaining bank credit, which may explain some of the growth in commercial lending by finance companies. Further, real estate, which has traditionally served as side collateral for many small business loans, has either declined in value in many parts of the country or is not appreciating as rapidly as it has in the past.

No discussion of credit availability would be complete without the scrutiny of the so-called fear factor. This is a concern on the part of some bankers that our examiners are overzealous and hypercritical in reviewing and classifying loans. Such conduct, it is claimed, discourages bankers from taking prudent risks in lending. We hear that examiners are so tough and intimidating that they are a large part of the credit availability problem.

But we also hear conflicting criticism. FDICIA sent the clear message that Congress did not believe we were doing an adequate job. This was recently echoed by the General Accounting Office's critical report on the adequacy of examination.

Which is true? Are we too tough or are we too easy?

I would suggest neither. Lending is a complex judgment process, and opinions on creditworthiness may vary.

However, to state again what we have stated many times before, the FDIC strongly encourages banks under our supervision to make sound loans to businesses, consumers, and others in support of their local communities and their economy generally. We believe our examiners have received this message and, by and large, are not making unreasonable demands for documentation and are not being especially critical of businesses or other types of lending.

However, it is important to remember that banks are not venture capital firms. They do not participate in the upside potential of business. If the business is successful, the loan is repaid. No more.

Further, banks have a narrow margin for error. They cannot afford many losses. They must have reasonable assurance of repayment. Our examiners expect no more than reasonable assurance of repayment when they review loans and assess the overall condition of a bank.

In terms of financial condition, are the banks in shape to lend? I would suggest the industry as a whole is well-positioned to increase lending to borrowers of all types, including small businesses. At the end of 1992, 11,361 or 95.8 percent of all BIF-insured banks qualified as well-capitalized under our definitions. These banks held 87.3 percent of all the assets in the BIF-insured institutions. In short, the banking industry has ample liquidity and is in a position to lend.

But we must keep in mind that many small businesses are reacting to the slow pace of the recovery by shoring up their balance sheets, conserving cash, and reducing borrowing. There is a widespread business practice in recessionary times to do that, to shore up the balance sheet and conserve cash. Often, managers will await an upturn in business or prospects before committing to any additional borrowing to finance working capital needs, expansion, or capital expenditures.

Even so, we are working to bring the banking industry's liquidity together with small business borrowers.

Mr. Chairman, my statement describes in detail the program to stimulate credit availability that the Federal regulators issued on March 10 and what we have done since then to meet that.

I just want to note that on March 10 the agencies issued a policy statement to permit our strongest banks and thrifts to make and carry small- and medium-sized business loans with only minimum documentation, subject to the limit of 20 percent of capital that Comptroller Ludwig has mentioned. Agency staff are hard at work devising implementation strategies for the remaining elements of the administration's program. We are confident that the initiatives will prove very helpful in eliminating unwarranted impediments to small business lending and opening new opportunities, which both

banks and small businesses can reasonably be expected to use to good advantage.

Mr. Chairman and members of this committee, my written statement also includes a discussion of the progress of the financial regulatory agencies in identifying possible changes in the law that may be appropriate.

I would be pleased to respond to questions that you or any members of the committee may have. Thank you very much.

Chairman LaFalce. Thank you very much, Mr. Hove.

[Mr. Hove's statement may be found in the appendix.]

Chairman LaFalce. Our final witness, Mr. Fiechter, the head of the OTS, Office of Thrift Supervision.

TESTIMONY OF JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. Fiechter. Good morning, Mr. Chairman and members of the committee. I am pleased to be here today to discuss the important role savings and loans have in meeting the credit needs of the Nation.

The primary purpose of savings associations, reaffirmed in FIRREA, is to make housing and consumer finance loans. Thrifts are fulfilling this mission.

The industry has emerged from its recent crisis approximately one-third smaller than just 4 years ago. Obviously, today's thrift industry plays a reduced role in the overall credit granting function in our economy.

Notwithstanding the significant restructuring of the thrift industry, however, today's savings associations remain active lenders. Thrifts have 70 percent of their portfolios, more than $560 billion, in residential, housing-related finance, and consumer loans. This percentage has been remarkably constant over the last several years. Thrift investments in Government securities are currently less than 5 percent of their portfolios, a level that has also been constant over the past several years.

While thrift portfolios have remained relatively unchanged in recent years, thrifts have added slightly to their holdings of residential and consumer loans and reduced their holdings of commercial loans, commercial real estate loans, and mortgage-backed securities.

The reduction in nonmortgage loans is to be expected. FIRREA's combination of generally higher minimum capital standards, the limitation on nonresidential real property loans, and stricter loans-to-one-borrower rules required thrifts to increase their capital while reducing their risk. The tougher qualified thrift lender test mandated a refocus by thrifts on residential housing loans.

Although the thrift industry has concentrated its lending activities in the home mortgage and consumer finance areas, we are aware that not all of those credit needs are being met and that some thrifts are retreating from their traditional role of extending credit for single- and multifamily construction lending.

Many home builders would meet the definition, I believe, of a small business. Over the past 5 years, thrifts have significantly reduced their underwriting of construction loans. Total construction

lending has decreased from over $23 billion in 1988 to under $12 billion in 1991, representing an almost 50-percent decline.

Lending for nonresidential construction loans declined from over $7 billion in 1988 to under $1.4 billion in 1992. Multifamily construction lending declined from $4.6 billion in 1988 to $1.2 billion in 1992. These declines mean that today's thrifts are underwriting only 20 percent of the nonresidential and multifamily construction loans that the industry underwrote in 1988.

Given the importance to our economy of a vibrant housing market, including multifamily buildings where much of the Nation's affordable housing stock is, the Office of Thrift Supervision is working to identify and, where possible, remove regulatory impediments to residential construction lending.

In addition, we are evaluating ways we can do more to encourage thrifts to meet other credit needs in their communities, particularly housing for low- to moderate-income borrowers.

I assure you that, as the primary thrift regulator, OTS does not want its supervisory policies or any misunderstandings that might arise from them to interfere with savings associations' ability to make sound loans to creditworthy borrowers, especially when the loans are to finance housing. With this in mind, we are reviewing all of our supervisory policies and examination practices.

We have also been working closely with the Federal banking regulatory agencies and the Treasury Department on actions to expand credit availability. The first initiative was directed toward small- and medium-sized businesses and farms.

We are also currently reviewing the burdens imposed by our appraisal requirements and our examination processes and procedures.

At this point, I would like to discuss OTS examiners. FIRREA put examiners under heavy pressure to closely scrutinize banks and thrifts. Their response, in some cases, may have resulted in instances of overly restrictive examinations. This, in turn, may have caused some financial institutions to tighten credit more than was appropriate.

The President's program is intended to encourage examiners to rely more on their experience and good judgment. The financial institutions' regulatory agencies are communicating this message to the industry and urging examination staffs to use their experience and good judgment in implementing the President's credit availability program.

OTS will hold a National Senior Examiners' Conference in Dallas in 2 weeks. Approximately 250 of our senior examiners and field managers from around the country will meet to discuss OTS's role in regulating the thrift industry. A specific theme throughout the conversation will be how the examiners' role is changing in the context of the improving thrift industry. Credit availability, community reinvestment, and affordable housing will be major topics of discussion.

Today's thrifts continue, I believe, to fulfill their primary role of providing funding for residential housing and consumer finance. We believe that the industry and Government, working together, can do more to ease the flow of credit in nontraditional lending areas and are working toward that end.

Thank you for the opportunity to discuss the thrift needs.

[Mr. Fiechter's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Fiechter, Mr. Hove, and Mr. Ludwig.

The Clinton administration has estimated the stimulative impact of their regulatory and administrative changes at about $46 billion, I believe. How was this estimate arrived at? Is that something that was just picked out of the air? How can anyone really predict with any accuracy the actual increase in lending that will result from these changes? Have the banks themselves made specific pledges of increased additional lending?

Would you care to comment on that, Mr. Ludwig?

Mr. Ludwig. Mr. Chairman, as you know, the President's program has a number of detailed provisions. If you look at one of the provisions that has already been fleshed out in detail—the minimum documentation basket—you'll see that the bank can use that basket for up to 20 percent of its capital. We estimate that between $38 and $50 billion of loans can fill up the basket. This is only one item of the President's program.

Chairman LaFalce. But how do we know that will be new lending that wouldn't otherwise have been made?

Mr. Ludwig. That is a very good question.

There are several things that encourage banks to make new loans.

First, I have talked to a number of bankers who have said there are loans they are going to make today that they would not have made prior to this basket. Over the weekend, I spoke with one banker from a large institution who is rolling out a small business program in the billions of dollars. Second, there would be no reason to put loans in the basket that have already been reviewed by examiners. If they are not paying loans, they don't stay in the basket. We will be looking at the basket over time, measuring how it grows. If demand is there, I think all of the basket will fill up. The demand situation however, is something that we can't control.

Chairman LaFalce. A lot of renegotiation takes place, too. Can you transfer some loans that have already been made but are slightly renegotiated into that basket, too?

Mr. Ludwig. As you know, we are looking at the best banks in the country—CAMEL-rated one and two—and well- and adequately capitalized institutions. We have considered and are concerned about the possibility of gaming the basket, that is, taking advantage of it in a way that is really not intended. We are going to be scrutinizing that very closely. But we believe the strong institutions will use the basket responsibly and use it to increase lending.

Chairman LaFalce. Does anyone else want to comment on that?

Mr. Hove. I would comment that I agree with what Comptroller Ludwig has indicated, that it is happening not just in the large banks, but it is also happening in the smaller banks, in the smaller communities, where, to a large extent, they make a great majority of their loans to the smaller businesses. They don't have the opportunity to make large loans to large businesses. So, a large percentage of their loans are to small businesses.

The conversations that I have had with bankers indicate a willingness to use the basket and to use it for new loans in their communities.

Chairman LaFalce. Mr. Ludwig, what is the current status of the administration's community development bank proposal?

Mr. Ludwig. Mr. Chairman, the President and an interagency group are actively looking at the community development bank issue. I am part of that effort. This is something the President cares a great deal about. I would like to discuss it more fully, but I don't want to preempt the President. In the not-too-distant future, the President will roll out a new program in the community development bank area, but I just can't preempt the President.

Chairman LaFalce. I tend to think it would make great sense to use existing community development entities by providing incentives for the private sector, including commercial banks, to provide these entities with financing, perhaps in return for some CRA credit, as opposed to establishing some wholly new set of institutions. I hope that the administration doesn't make the mistake of trying to rebuild the world anew rather than taking existing institutions and helping them perform certain functions in a better manner than they have in the past, whenever organizational or incentive techniques can be used.

Mr. Ludwig. Mr. Chairman, those are very good comments. I am very concerned personally that we use all our levers to the maximum extent possible. This is an enormous national problem.

I am also actively involved in looking at what more can be done with CRA, as I mentioned in my statement. We are looking at all the programs that are available to improve lending to low- and moderate-income areas and low- and moderate-income individuals generally.

In a country as large as ours with as many problems as there are, the President's goal of 100 community development banks, while significant, doesn't solve all the problems but is a valuable new initiative. If you look at the South Shore experience in Chicago, you'll see a fine community development bank making a big difference. This is an opportunity for some material change, but it is not the whole picture, by any means.

Chairman LaFalce. I caution you, and I caution the administration, in attempting to deal with our problems to be prudent. Don't think that by setting up 100 models or pilots—if they cannot be replicated throughout the entire country—that you are going to be accomplishing very much good, because, how many banks do we have in the United States of America right now?

Mr. Ludwig. We have 12,000, more or less.

Chairman LaFalce. If we take 100 small little community development banks where we presently have over 12,000 servicing the United States, plus a myriad of other financial institutions, that is not going to do very much good. We might spend an awful lot of time using ink and paper on it, but it wouldn't really do that much good. Better to change the way, or facilitate the way, these 12,000 institutions can operate than just focus in on 100.

I mention that also with respect to the concept of enterprise zones. I won't go beyond that, but better to improve the ways that our tax laws function for all and better to improve the ways our

public assistance infrastructure programs can assist all, than to target it to a certain small select group within America, and create the expectation of doing the same thing all over, when you don't have even one scintilla of a possibility of coming up with the moneys necessary to replicate throughout the entire United States what you might be doing in these pilot areas.

You would be better off, it seems to me, to see what your existing mechanisms, tools, and resources are, and enhance them so that they could be applicable to all.

Mr. LUDWIG. I hear your comments, and I will definitely take them back to the administration. You can be assured that this is an area I care deeply about personally. I care passionately about low- and moderate-income lending. We will be using all our existing levers as aggressively as we can to improve this situation.

Chairman LAFALCE. Mrs. Meyers.

Mrs. MEYERS. Let me see if I understand something. You have said that the maximum loan could be $900,000 or up to 3 percent of the bank's capital.

Mr. LUDWIG. Whichever is lower.

Mrs. MEYERS. Yes. Then you said that the whole basket could be 20 percent of the bank's capital.

Mr. LUDWIG. Yes.

Mrs. MEYERS. So that if all the loans were the maximum, you would make about seven loans?

Mr. LUDWIG. That is correct.

Mrs. MEYERS. OK. They probably wouldn't all be the maximum is what you are thinking. Seven loans in a community doesn't sound like very much.

Mr. LUDWIG. We don't expect people to use the maximum for every loan, and 20 percent of capital is a lot. As you know, Congresswoman, the small business loan cutoff is $750,000, and the average small business loan is quite a bit less than that. So, we would expect to see a pattern where there are dozens and dozens of loans made in this basket, and the responsible banks, I think, will do that. Occasionally, one will make a larger loan to a medium-sized entity or to a small business in a peculiar situation that needs the maximum, but we don't expect that to be the pattern.

Mrs. MEYERS. All right.

Your stack of regulations there is very impressive, and it looks like it is about 12 or 15 inches tall, and you are hoping to reduce it to about 2 or 3 inches. Does it get to that height because it is just layer upon layer upon layer over a period of years? How do we get in that kind of shape?

Mr. LUDWIG. That is a very good question. I have kidded my staff that this is a lawyer's full employment act. As you know, I was a lawyer before I became Comptroller.

There are two reasons for this. One, the OCC has been around for 130 years, and there is a tendency to add layer upon layer upon layer rather than use self-discipline to go back and weed out those regulations that simply over time don't make a difference. They made a difference at one time possibly, but they don't make any difference now.

Second, there is a tendency to take the easy road sometimes and not define things as crisply as one ought to do. We learn over time

that one can define things more crisply and simplify them. It is a hard job. It doesn't make headlines to go through this pile and try to put it into plain English and to put it all in one volume so any business person can use it, and so they don't have to hire a team of lawyers or a consultant every time they want to do business.

But this is our responsibility as regulators, and I take it very seriously. It is not going to happen tomorrow, but we have somebody we are hiring especially for this project at the OCC, and we are going to go through every regulation, A to Z.

Mrs. MEYERS. Well, I don't know whether it will make headlines or not, but it will certainly get a lot of applause in the business community and certainly from my bankers. I think everybody here would have the same experience.

Along those lines, let me ask this question. I know that a lot of the problems of agencies and regulators are caused by Congress. I can think of a couple of specific examples where Congress passed laws—one of them I wasn't here for and one of them I was present. They were evidently so vague that when the law that we passed got to the regulators it resulted in regulations that were just impossible for people to live with.

One was the now famous auto log that took place before I arrived here. The law was passed in 1984, and it required people to keep track of their mileage—do you all remember that—if they were going to take a deduction.

Then the other one was section 89 that our chairman took some leadership on to get repealed where, again, I think the idea behind the law was not bad at all, but when it came out, it was evidently so vague that when it was put into regulation it was some 40 pages long. I never have had anything that got such an outcry from the business community, and that was ultimately repealed.

How much of this is Congress' fault? I would like to have you each comment on what Congress can do to help you develop regulations that are crisp and to the point? How can we be of assistance in that process, rather than passing a law and then just pointing our fingers after the outcry begins?

Mr. LUDWIG. Let me say several things on that. It is our absolute obligation to enforce the law as Congress intended. I don't think I can identify legislation that needs changing as much as starting on this huge regulatory pile is necessary. We have an enormous amount that we can do before we get to whether there ought to be changes in law.

At the same time, there is one thing Congress can do, even while the regulators do this. You have a wonderful network of people in your districts who have genuine, real-life concerns which we don't hear. We certainly want to bring this input into the OCC and this regulatory effort. We are making efforts to interface with congressional staff and Members to hear complaints, to try to respond to them, and to share in this process.

When and if we bump up against a law that needs changing, we will certainly be back to you.

Mr. HOVE. Let me comment, because I would underscore what Comptroller Ludwig has said.

It is our intent to uphold the law precisely, but to not go any further in the regulation than is necessary so as not to put any addi-

tional burden on the industry. Each of us sits on the Federal Financial Institutions Examination Council, along with a Federal Reserve Board representative and a credit union representative.

Under section 221 of FDICIA, you asked for a regulatory burden study. We have completed that part of the study. The FFIEC will now be bringing forward——

Chairman LaFalce. Did we ask within that regulatory study to classify all those burdens imposed by FDICIA itself?

Mr. Hove. Well——

Chairman LaFalce. Why don't you do it that way? With a subset on FDICIA, it might make it more interesting.

Mr. Hove. All right. What we will be coming forward with is the recommendations or suggestions for change in statute or statutory changes that could relieve regulatory burden, and that will be forthcoming from the FFIEC in the next few months.

Mr. Fiechter. I have one suggestion for better rules or better statutes from our standpoint. That is, provide more discretion to the agency to differentiate, particularly between weak and healthy institutions. If we could, at least, exempt our very well-managed, well-capitalized institutions from some of these rules, I think that would go a long way toward easing the burden for many of our institutions. We don't always have that discretion.

The example of the approach we are taking for the character loans is one where we applied it just to the healthy institutions. I don't think it raised safety and soundness concerns.

The more of that flexibility you could give us, I think the better we would do our jobs.

Chairman LaFalce. The time of the gentlelady has expired.

Mrs. Meyers. Yes; I would like to just say quickly to the committee, Mr. Chairman, that I think this kind of underscores one of the principal roles of this committee. Maybe we don't have as broad a jurisdiction, and we aren't on the floor with as much legislation, but this committee's role is to work with agencies and develop improvements in regulations for the business community. I think we have done a very good job of that in the years that I have been here.

So, while I don't think we have been critical of you, I do think that we have tried to bring to you over and over again the problems that we see in our communities with regulations.

Chairman LaFalce. You have 4 more minutes, if you want. No?

Before I call on the next Member for questions, I just want to point out—not so much to Mr. Fiechter but to the other Members—Mr. Fiechter made a point that very often the discretion of the regulators was constrained, which did not allow them the ability to respond to different institutions in an appropriate fashion.

I think it came about in large part because of a frustration level on the part of the Congress, which should not have been reached, which became irrational, and that said we can't give regulators flexibility, that we can't give them discretion because there will be problems if we give them flexibility, if we give them discretion. So, we will pass legislation that almost eliminates the ability of regulators to exercise their good judgment. We will just demand that they act in a certain way.

Did legislation like this pass? Yes; unfortunately, it did. Individual legislators wanted to appear tough, and the only way to appear truly tough is if you took discretion away from the regulators and mandated that they follow a certain course of action in certain circumstances. The regulators really know that certain of those statutes should be changed. They are not speaking now because they are afraid of taking on those legislative changes and not succeeding. That is my judgment.

Why take it on if you know you are going to run into some troubles? Let's try to do these other things first. But there were tremendous overreactions.

On the other hand, Mr. Fiechter, regulators were given a certain amount of discretion, that because of the climate of fear that may have been brought about by legislators and the media, regulators were afraid to exercise.

For example, you do have the authority under FIRREA to permit capital plans for financial institutions if they are qualified, if you think that they have good management, if they are operating according to a financial game plan that means their losses will be less in the future or they will become profitable and that their capital ratios will improve. I don't know that that discretion, that authority, has been used at all; maybe one instance. I am not even sure about that.

Is there now some new thinking within OTS that you will utilize the discretion that is there to keep institutions that appear to have the promise of viability open if the capital plan does go beyond the 1994 period?

Mr. FIECHTER. To give you a simple answer, yes.

Chairman LAFALCE. Thank you.

Mr. Hilliard.

Mr. HILLIARD. Mr. Ludwig, do you have any idea what kind of time period we are speaking about on the community bank proposal coming forth?

Mr. LUDWIG. Mr. Hilliard, I think that we are looking at the next several months. The President is actively looking at this. The timing is really hard to pinpoint because it is under active study by the administration. Obviously, everybody would like to do it sooner rather than later. A great deal of time has been spent on this, but it is very hard for me, given the fact that it is an interagency activity and the White House is actively involved, to give you a date. That is really up to the President.

Mr. HILLIARD. Thank you.

Chairman LAFALCE. Mr. Sarpalius.

Mr. SARPALIUS. Thank you, Mr. Chairman. I just would like to make a point.

Yesterday, our subcommittee held a hearing on trade and how this country is way behind other countries in being aggressive in trying to capture world markets for small businesses. We had several leaders within the small business community testify before our committee. Each one expressed that one of their biggest problems is getting loans approved from banks, and that banks do not have the confidence in small businesses competing in the world markets.

I just would like to express to you that, as we look at the problems in banking, the future is going to be global markets. Many

small businesses can compete in those markets, but your assistance is critical to them. I wanted to make that point to you because, in that meeting yesterday, that was a very strong concern that small business is expressing.

Chairman LaFalce. Thank you very much.

Mr. Strickland.

Mr. Strickland. No questions, Mr. Chairman. Thank you.

Chairman LaFalce. Ms. Danner.

Ms. Danner. No questions, Mr. Chairman.

Chairman LaFalce. Mrs. Clayton.

Mrs. Clayton. In response to Mr. Hilliard's question about the community development bank proposal, there is still, currently, regulation with the banking institutions right now to make a concerted effort into the community of their matching area, particularly to bring in those communities that have not been banking with them, the CRA requirement.

What I would like to ask you, as you look at the availability of credit for small lenders, do you have a threshold that, among you, gets to be troublesome, that if a small lender comes in and wants to borrow less than $10,000, they go through more scrutiny than if you wanted to borrow more?

Mr. Ludwig. That is precisely the purpose of this program and the basket that I described earlier. The objective is to make the smaller credits with the absolute minimum documentation requirements. The banker can use his or her judgment to say that this looks like a good credit to me. It is a small one. I don't need layers and layers of documentation which make the loan uneconomic to make. Similarly, we are looking very hard at the real estate appraisal rules with the same vision. Why layer additional expense on a loan that is too small to bear it?

I think your comment is well-taken. There are a lot of good small loans. We don't want to have them layered with so much documentation and other requirements that they become uneconomic to make. These are the areas where bankers should use their judgment.

Mrs. Clayton. I guess, in addition to that point—I think you are right—is that the obligation of a lending institution really is to make loans available if they are creditworthy. If there is no official barrier going too low, it pushes out the whole entrepreneur spirit in the first instance.

You can apply that to one side of the track where the appraisal is going to be low, so why go over that side? It also applies to the types of lenders you want to be bothered with.

In addition to the paperwork and in addition to the regulation, it has a mind-set as to the type of lender that is worthy to be engaged with. Either they are too small or they are in the wrong side of the neighborhood or their real estate is too low. Do you follow me?

Mr. Ludwig. I sure do, and I am very sensitive to that. As you know, that is my personal concern. I feel very strongly about community lending. The President's program addresses this both in terms of specific regulatory changes, and in terms of the importance of the Community Reinvestment Act, and fair lending proposals.

The Community Reinvestment Act holds more promise than it has shown. The President has talked about performance, not process, and we are looking very hard right now at reorienting this system in a way that will focus a great deal more attention on performance.

Mrs. CLAYTON. I inadvertently said lenders rather than borrowers, but you understood me.

Mr. LUDWIG. I understood.

Mrs. CLAYTON. You understood I understood the difference, too, right?

The banking institution now has that obligation—and I guess my point is I want to see the President's program—and I especially embrace the President's program, but that is not for the lending institutions to wait for that to happen. There are already regulations and banks doing that now. To kind of pause and say we are waiting now for this great program, that takes away, seems to me, the initiative or the obligation for the banking community to do an enormous amount of positive examples by engaging in that while they wait for this unveiled program.

Mr. LUDWIG. Yes; I hope they would not be waiting. We don't intend them to wait. They have legal obligations right now, which our examiners are out enforcing.

I have been going, as Congressman LaFalce knows, to every one of our 87 offices around the country. I am going to see as many examiners as I can in order to come to an understanding with them about the President's program and to specifically talk about CRA/community lending.

Chairman LAFALCE. The most important thing you can do is to reach out to your examiners and tell them, be reasonable, do what you think is right. If you think you should be tough, be tough. If you think you should be exercising some discretion, exercise your discretion, and don't be afraid of making a mistake. We are not going to come back and kill you because you made a mistake and kept a bank open if you thought there was a realistic chance of it surviving. Just be reasonable.

Mr. LUDWIG. I couldn't agree with you more. I think that is exactly right.

Mrs. CLAYTON. Mr. Chairman, has my time expired?

Chairman LAFALCE. You've got more time, now.

Mrs. CLAYTON. Oh, OK, all right.

You made a good point in your written statement about the collection of information. Do you perceive that to be burdensome, to collect the size of the business as well as the nature of the business, the sex of the borrower, the race of the borrower, and the neighborhood of the borrower? You find that to be——

Mr. LUDWIG. I think you are driving at a very important point. We cannot burden our financial institutions by having requirements that make lending more difficult and more expensive. At the same time, I am very much concerned that we have sufficient information so that we can determine whether banks really are fulfilling their obligations. The President's program and his comments on CRA—performance not process—drive us in that direction. I have kidded my own staff that it seems like it is the old Wendy's commercial. Where's the beef? In other words, we want to be able

to determine that credits are being made in low- and moderate-income areas. We are looking very hard at how that can be done in the most efficient way so as not to overburden the banks but, at the same time, be able to tell whether they are fulfilling their obligation to make loans to their communities and loans across racial and ethnic lines.

Mrs. CLAYTON. OK. Thank you, Mr. Ludwig. Mr. Chairman, thank you.

[Mrs. Clayton's statement may be found in the appendix.]

Chairman LAFALCE. Let me follow up on that question because I think we need a little fuller response.

Sections 122 and 477 of FDICIA required our four bank regulatory agencies to collect data on lending to small businesses and small firms, but there have been some criticisms of the final rule as inconsistent with congressional intent.

For example, the rule provides for collection of data by the size of the loan rather than annual sales of the borrower, as originally proposed. Could you comment on the regulation which was issued and apprise me of efforts being undertaken by the new administration to provide the necessary data on small business lending?

We need certain data to ensure that the small business community and certain segments of the small business community are being attended to by our financial delivery system. We don't want too much data because, number one, we won't use it. Number two, it will be counterproductive, imposing too much of a burden. Have you made a judgment on this rule, Mr. Ludwig?

Mr. LUDWIG. As you know, I have been on the job only 3 weeks. I am well aware of this specific rule, which is an attempt to implement section 122 of FDICIA. The notion was that we collect data by loan size and that the process is not burdensome to the bank. Historically, this is a pretty good gauge as to which businesses are receiving the money. At the same time, I have requested from my staff a full briefing on that because I have just arrived. This is an important area. That data is important, and I want to ensure that the way we are collecting it results in what Congress wants. We are trying to get an understanding of what is really going to small- and medium-sized businesses. Your comment is well taken. I haven't decided myself whether the recently announced approach works, but I am very sensitive to that issue.

Let me say one other thing, Mr. Chairman. I am issuing a letter to examiners today that I would like to insert in the record because I think you will find the exact same approach—actually, maybe some of the same words that you just uttered about instructions to examiners—in the letter. I think it is very important that the examiners get that message.

Chairman LAFALCE. That is good.

[The information may be found in the appendix.]

Chairman LAFALCE. Let me also give a word of advice to Members of Congress. Let's invite the regulators in as often as we deem necessary or desirable, but let's not bring the examiners into congressional hearings and roast the hell out of them. Because then the examiners are going to say, oh, boy, I will never get roasted if I am ultra, ultra conservative and demand $100 million in reserves rather than $20 million. They will only roast me if I am not tough

enough. They will be afraid to be reasonable. They will just stand on their heads to cover their behinds. This is what happened.

To a certain extent, we have to remember that we have met the enemy, and it is us.

Mr. Hove, I can't go into as many questions as I want because shortly, at 10 o'clock, we are supposed to be marking up the RTC bill, and I really want to be there. I think it is important.

But a few more questions. Is it appropriate to apply risk-based standards contained in the Basle Accord to small banks and thrifts as well as to banks with international lending operations? You and I have gone around on this a bit before——

Mr. Hove. Yes.

Chairman LaFalce. I have been led to understand that at least some European countries do not apply strict Basle standards to their smaller institutions but use alternative capital standards for smaller institutions. Might we consider doing something similar? I wonder, on the other hand, if treating small banks differently from larger banks might bring about an unlevel playing field for U.S. banks in their own markets, putting regional banks with international operations at a competitive disadvantage? Some of these issues are double-edged swords.

Mr. Hove. You raise several issues, and the first is the issue of other countries not applying the Basle standards to all of their financial institutions. However, their financial institutions have different charters for different types of institutions. We use the same——

Chairman LaFalce. We do, too.

Mr. Hove. Well, we do, except that a national bank charter is the same in New York City as it is in a small, rural community in this country. Moreover, a large State-chartered bank in New York City is virtually the same as a small, community, State-chartered bank in upstate New York. So, we find all different sizes of institutions that really have the same charter here.

There has been some discussion as to whether we could use different capital standards. In other words, could we use the Basle standards for those institutions that have international transactions and then use——

Chairman LaFalce. Not necessarily different capital standards but different weightings.

Mr. Hove. Different weights. That is correct.

Because when we look at the smaller institutions, what we find, as I mentioned in my comments, is that such institutions are making a lot of loans that are 100-percent risk weighted. They are making loans to small business. They are making loans to agriculture. They are making loans to consumers. Each of those have 100-percent risk weighting.

Now, in some cases, yes, they are making mortgage loans that have a 50-percent risk weighting. But when they do that they are really having a very high capital standard, and the imposing part of the capital standard is the leverage ratio as opposed to the risk weighting.

Chairman LaFalce. Which raises the separate question of whether or not we should have that leverage ratio. But I won't go into that now.

Mr. HOVE. Well, you might raise that question.

It is interesting, also, because we have looked at the leverage ratio and considered whether that cuts tighter than the risk-weighting ratios. As we have looked at it, our research division in particular, we found that there are 47 BIF-insured banks in the country, representing four-tenths of 1 percent of all the BIF-insured banks and representing three-tenths of 1 percent of the assets there, that meet the well-capitalized risk weighting, that is, the 10 and 6, but fail to meet the 5-percent leverage ratio. So, if you lowered the leverage ratio to something less than 5 percent, you really would only affect 47 banks by doing that.

So, I am not sure that elimination of a leverage ratio really would change that, again because some of the smaller banks have most of their loans in the 100-percent risk weighting.

Chairman LAFALCE. Of course, I wasn't asking about the leverage ratio.

Mr. HOVE. I understand that. But the question is, should we apply different standards to the smaller banks than we do the larger banks? It is an issue that I think we need to look at. I can't give you an answer.

Chairman LAFALCE. Well, as you look at it, if you have some internal memo that thinks about it—I am not saying it comes to any conclusion—please share it.

Mr. HOVE. Yes.

Chairman LAFALCE. Is there any leeway within the Basle Accord to adjust risk weighting to remedy what I believe is a bias toward Government securities, agency securities, mortgages, and mortgage securities, as opposed to commercial loans?

Admittedly, the intent of the Basle Accord was to reflect the relative riskiness of different types of assets, but hasn't the effect been to make banks prefer holding alternative instruments to loans? Because loans are 100-percent risk weighted. Of course, that is what the business community, especially the small business community, needs. So, haven't we just geared bank lending practices away from the small business commercial loan?

Mr. HOVE. It appears that the Basle capital standards certainly put an incentive on Treasury securities and may be one of the reasons. However, there are a lot of other reasons why banks have invested in Treasury securities.

Chairman LAFALCE. The interest rate spreads right now are a very, very major reason also. I understand that. But is anybody thinking about the disincentive to make a small business loan because of the Basle Accord risk weighting?

Mr. LUDWIG.

Mr. LUDWIG. Mr. Chairman, two things bear on that question. Most smaller banks are really very heavily capitalized and yet hold quite a number of securities. Indeed, if you look through the banking sector at the banks that are well-capitalized versus the banks that are more marginally capitalized, you find that the banks are even capitalized in excess of the well-capitalized standard. You find there is not a difference in terms of their holding securities or not, which would suggest that is not a constraint.

Chairman LAFALCE. Maybe it would make a nice profit given the present spreads. But, also, they like marketing their high-capital

ratios, and if they invest in commercial loans, that immediately decreases their capital ratios.

Mrs. MEYERS. Excuse me, Mr. Chairman. Did you just say that there is no difference in the well-capitalized ones as opposed to the not-so-well-capitalized ones?

Mr. LUDWIG. Very little difference between those that have capital in excess of requirements and the institution of average capitalization in terms of the quantity of securities they are holding. This would suggest that they are not being constrained by capital, that this is not the determining factor in the holding of securities. But I share your concerns in that area. We will be introducing, in the not too distant future, interest-rate sensitivity into the risk-based capital standards, and that will have some impact on securities holding.

Chairman LAFALCE. When do we project to do that, to incorporate interest rate sensitivity into risk-based capital standards?

Mr. LUDWIG. In the next several weeks.

Chairman LAFALCE. What might that do? Drop it from 100 percent to what?

Mr. LUDWIG. It depends on a bank's portfolio, how far out they have gone, what the interest rate sensitivity characteristics of their securities basket is. But it will have some impact. I am not saying that it will have a dramatic impact in terms of a disincentive to hold securities, but it will have some impact.

Chairman LAFALCE. You don't think it will have any impact on the Government's ability to finance our debt, do you? Because it might diminish——

Mr. LUDWIG. No; we don't think so.

Chairman LAFALCE. Looking at the flip side. Did somebody else want to comment?

Mr. FIECHTER. When you started to mention lowering the risk-based capital requirement of 100 percent, it doesn't affect the small business loan per se, but what adding an interest-rate risk component will do is make holding Government securities more expensive. But you have clearly picked up on that on the funding side of that equation.

Chairman LAFALCE. Yes; this has flipped everything.

How are we going to monitor the efficacy of the President's credit crunch proposal? What plans do we have so that we can, 6 months to a year, year and a half from now, look back and say this is the impact that it had? What system of accountability are we attempting to bring into the system?

I think we need to do this with almost everything we do. Are we thinking about that, measurements for success or failure?

Mr. LUDWIG. Absolutely. First of all, it is a very hard thing to do, as you change regulation after regulation, to figure out which regulation is most effective. Some of it is anecdotal. We do have 3,300 OCC examiners out there, and we talk with them to find out whether this is having an impact in their areas. Beyond that, we have recently instructed our examiners to begin to measure this new minimum documentation basket to see how it is growing. We will be looking at this although it is a lagging indicator. We are definitely concerned about trying to measure and determine how

effective this program is over time. It is very difficult, but it is also very important.

Chairman LaFalce. I would like to, with your permission, keep the record open so we can submit additional questions to you and have you respond in writing.

Mrs. Meyers or Mr. Strickland, do you have any final questions?

Mr. Strickland. No questions.

Mrs. Meyers. Mr. Chairman, I would ask unanimous consent to have the opening statement of Congressman Ron Machtley entered into the record.

Chairman LaFalce. Without objection, so ordered.

[Mr. Machtley's statement may be found in the appendix.]

Chairman LaFalce. Gentlemen, thank you very, very much for your presentation. You have been very helpful.

[Whereupon, at 10:30 a.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

OPENING STATEMENT OF THE HONORABLE JOHN J. LaFALCE
CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Hearing on the Administration's Credit Crunch Proposals
April 29, 1993

Today we continue a longstanding inquiry that this Committee has made into the causes of the credit crunch, its implications for small business and the broader economy, and possible policy changes that could ensure the flow of credit to this Nation's smaller firms.

There has been an important development regarding credit availability that I have been gratified to see. On March 10, President Clinton announced a credit crunch initiative designed to jump start a renewed flow of credit to small businesses.

In doing so, the President emphasized something that Members of this Committee have long known. It is our small business sector that has increasingly become the engine of our economy, providing the innovation and job growth on which a growth economy can be built. As the President himself noted, "if you had to put in a sentence why this has been a jobless recovery it's because small business job creation hasn't offset big business job losses." That must change if our goal of achieving a real recovery that provides real opportunity is to be met.

The regulators are now engaged in the implementation of the President's initiative and a review of current law to determine whether additional statutory change is required. It is important

that we monitor that process closely to ensure that the desired impact is achieved.

At the time the President's program was unveiled, an Administration spokesperson indicated the initiative could mean that up to $46 billion in additional lending would be made by sound institutions. That would be an enormous achievement. But our expectations must be realistic if we are to develop sound policy in this area. It is my understanding that banks could simply re-classify character loans already on their books into the pools that they are now authorized to create. If so, that could mean little or no new lending.

I would hope the regulators could provide us with some insight into their realistic expectations regarding the President's program; how it will be monitored to ensure that real new lending results; and what further changes are anticipated, either administratively or legislatively.

While the President's initiative is important, it is only a small part of what we must do. A key component of the economic stimulus package that failed to pass in the Senate was a supplemental appropriation for the Small Business Administration's 7(a) loan guarantee program. The SBA loan guarantee window is now closed, and it will remain closed unless and until additional funds are appropriated in another measure. This program has been the safety valve for small businesses during the credit crunch. As other sources of funding have effectively dried up for even the most creditworthy small firms, the SBA program -- which grew by 40% last year -- has taken up the slack. If it is not available to do so, we risk stalling the

economic recovery we have worked so hard to begin. As important as the President's initiative may be, it will take some time for it to have any real impact and it is no substitute for the program that is really doing the job now.

In the longer term, we must develop new and innovative mechanisms for financing small business. Even before the credit crunch, small businesses had a very difficult time getting the longer term fixed-rate financing that is so important for their health and growth. That need remains largely unmet. As important as the SBA loan guarantee program is, we can never realistically expect to expand it sufficiently to meet the full demand.

Sources of long-term capital do exist among our institutional investors. But there is no mechanism for making the link between those investors and the small business community. We can help make that link by expanding the secondary market in small business loans and I would hope to work closely with the Administration and appropriate regulators in that effort.

Finally, this is a highly technical issue but an important one. I would urge the regulators to look more closely at the risk-weightings under the Basle capital standards to determine if they create a disincentive to small business lending. The Administration is committed to community development initiatives. Community development requires small business development. Yet financial institutions are predisposed toward the kinds of investments -- government securities and housing lending -- that

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require the holding of less capital. In fact, our banks are increasingly buying government securities rather than making productive investments. I would hope we could consider exempting certain small institutions from the Basle standards or at least allowing a lower risk weighting for a portion of a bank's small business portfolio that is clearly directed toward community development. I would appreciate your comments on this issue.

Today we are pleased to have with us: Eugene Ludwig, Comptroller of the Currency; Andrew Hove, Acting Chairman of the FDIC; and Jonathan Fiechter, Director of the OTS. I understand that this is your first opportunity to testify before the Congress, Mr. Ludwig, so we are especially pleased to have you with us today and hope you will find the experience pleasant and worthwhile.

STATEMENT OF
U.S. REP.JAN MEYERS
RANKING MINORITY MEMBER
COMMITTEE ON SMALL BUSINESS

HEARING ON CREDIT AVAILABILITY

APRIL 29, 1993

Thank you Mr. Chairman.

I appreciate this opportunity to hear what progress the federal banking regulators are making in their efforts to improve credit availability for the nation's small businesses.

Let me state from the outset that I support safety and soundness regulation for the banking industry, but I also feel that our efforts to prevent losses have resulted in a number of conflicting and duplicative regulations.

I am certain that many of these regulations have forced bankers to spend more time worrying about regulators than about banking, and that they have caused a widespread fear of small business lending. An excellent example of this is tne banker in Texas who was forced to hire a compliance officer rather than a loan officer due to the regulatory burdens imposed on his institution.

I do not believe that all the problems of credit availability for small business can be laid at the door of the regulatory agencies, but I do believe that regulation has created major obstacles to effective lending. With that in mind, I support the President's efforts to reduce the regulatory burdens which impair the ability of this nation's banks to make credit available to small businesses.

I look forward to your testimony gentlemen.

STATEMENT FOR
CONGRESSMAN FLOYD H. FLAKE
BEFORE THE COMMITTEE ON SMALL BUSINESS
HEARING ON CREDIT AVAILABILITY
APRIL 29, 1993

GOOD MORNING MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. I WOULD LIKE TO THANK THE CHAIRMAN FOR HOLDING THIS HEARING TO FURTHER DISCUSS THE PRESIDENT'S PROGRAM TO ALLEVIATE SOME OF THE BURDENS FACED BY SMALL BUSINESS OWNERS SEEKING LOANS. ADDITIONALLY, I WELCOME OUR WITNESSES AND THANK THEM FOR THE TESTIMONY THEY WILL PROVIDE.

SMALL BUSINESSES ARE CONTINUING TO PLAY A MAJOR ROLE IN STIMULATING OUR ECONOMY AND EMPLOYING OUR DISPLACED WORKERS. HOWEVER, IT IS CLEAR THAT THE PRESENT LENDING ENVIRONMENT IS NOT ADEQUATELY MEETING THE NEEDS OF SMALL BUSINESSES. IN TURN, OUR ECONOMY CANNOT GET THE NECESSARY JUMP-START TO CREATE JOBS AND SUSTAIN GROWTH.

IN 1991 AND 1992 BANK LENDING TO BUSINESSES DECREASED BY $36 BILLION. THIS CAN BE ATTRIBUTED BUT NOT LIMITED TO TRENDS IN THE ECONOMY; A DESIRE TO IMPROVE BALANCE SHEETS FOR LENDING INSTITUTIONS; AND OVERLAPPING AND CONFLICTING REGULATIONS. WHILE SMALL BUSINESSES EMPLOY NEARLY TWO-THIRDS OF OUR WORK FORCE, WE CANNOT ABANDON THE NECESSARY EFFORTS TO ALLOW CREDIT WORTHY BORROWERS THE OPPORTUNITY TO THRIVE.

AFTER ASSESSING THE PRESENT REGULATORY REQUIREMENTS AND DETERMINING THE SAFETY AND SOUNDNESS OF BANKS AND THRIFTS, I BELIEVE THAT THE PROPOSAL PUT FORTH BY PRESIDENT CLINTON COULD PROVE TO BE QUITE SUCCESSFUL. IT IS MY HOPE THAT THIS PROGRAM TO REDUCE UNNECESSARY AND ONEROUS REGULATORY BURDENS WILL REDUCE

OBSTACLES THAT INHIBIT CREDIT WORTHY BORROWERS. AS A RESULT, BANKS WILL BE ABLE TO RETURN TO THEIR ROLE AS LENDERS AND SMALL BUSINESSES WILL RETURN TO THEIR ROLE AS JOB CREATORS.

ALL SMALL BUSINESSES, INCLUDING THOSE OWNED BY SOCIALLY AND ECONOMICALLY DISADVANTAGED INDIVIDUALS, NEED OPPORTUNITIES TO SUCCEED IN ORDER TO BECOME AN INTEGRAL PART OF OUR ECONOMY. TOWARD THAT END, I LOOK FORWARD TO DELVING INTO THE PRESIDENT'S PROGRAM AND THE INSIGHT THAT OUR WITNESSES WILL PROVIDE.

OPENING STATEMENT OF CONGRESSMAN BILL ZELIFF (R-NH)

Small Business Committee

April 29, 1993

Mr. Chairman, thank you for calling today's hearing about the availability of bank credit to small businesses and the President's program to stimulate bank lending. It is always a pleasure to discuss this important issue with such a distinguished panel of witnesses.

Without a doubt, the lack of credit availability is a major concern for small business these days. Being a small businessman myself, I have observed many of

my colleagues experiencing the lack of credit problem and have seen them suffer extremely hard times as a result.

New Hampshire is still suffering from the effects of a very difficult economic environment. Although interest rates are low, small businesses are still experiencing problems obtaining a loan. Small businesses are drowning in a quagmire of federal regulation. Our small businesses need help. What we need to do is create jobs and stimulate economic growth, starting by getting the government off the backs of American businesses.

On March 25 of this year I brought members from the NH business and banking communities together with representatives from the FDIC to discuss some banking regulation problems that are occurring in NH. I look forward to hearing what progress has been made since that important meeting.

I applaud the President for initiating a program to ease the lack of available credit. However, I think more needs to be done. This is a good first step but lets keep moving.

We have to go back to 1989 to see the beginnings of NH's problems. The reason for the problem in New England was that federal regulations came at the worst possible time. For instance, simultaneous to the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the increased capital levels it requires, the New England economy went through not just a cyclical decline, but a structural collapse.

Enormous hits were suffered by high-tech companies and defense contractors, two of the regions most important economic engines. In light of spreading economic decline, the Northeast was over-invested in real estate.

Once FIRREA was implemented in 1989, New Hampshire was already deep in a recession. Unlike other regions of the country, New Hampshire banks were caught holding non-performing loans as a result of the overextension of the real estate market.

While NH banks should have been using capital to absorb their losses, they were required to build capital under FDICIA in 1991, and this of course caused a structural collapse of the banking system in NH and New England.

As a result of the FDIC's takeover of 5 of the 7 largest state banks and FDIC holding 30% of New Hampshire's total banking assets, New Hampshire was burdened with an obvious problem.

We need to revisit past legislation which has gone too far in the name of safety and soundness. These would include FDICIA, FIRREA and even the Truth in Lending legislation. While I applaud the President for these steps, I am convinced we need to go beyond administrative tinkering.

I have been battling for reform since my first days here in Congress. Last month I held a hearing in Manchester, New

Hampshire to hear testimony about the credit crunch problem in New Hampshire and about the need for a pro-growth agenda.

Of course, there is now some recovery in sight, and there are loans now being slowly reinstituted, but the traditional post-deficit increase in bank credit is not happening this time. I think we need to investigate the cause of this problem. I submit, Mr. Chairman, that it has a lot to do with overregulation.

Mr. Chairman, we have an important duty here today. This country was built on the small business, and now we are faced with a problem that is jeopardizing our small businesses. I hope we can go beyond the excessive regulations and get down into the detail of the causes of the credit crunch. From there we can begin rebuilding what has been severely damaged. A remedy has to be found, and the Presidents program is a good start.

Thank you Mr. Chairman.

EVA M. CLAYTON
1st District, North Carolina

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STATEMENT FOR REP. EVA M. CLAYTON
COMMITTEE ON SMALL BUSINESS HEARING
29 APRIL 1993

Thank you. Mr. Chairman, I appreciate you holding hearings on this crucial subject. The availability of credit is a crucial factor in the future success or failure of our small business community in the United States. I believe that these hearings are a good beginning in developing the necessary legislation which can restructure the system to allow the small business owner to attain the needed capital.

Mr. Chairman, I am very concerned particularly about the situation that our minority small business owners find themselves. I believe that it is crucial to

focus on legislation which allows for a "level playing field" for all entrepreneurs. I have witnessed first hand the reality of the "credit crunch" in my district in eastern North Carolina. Poor rural regions in this country are in desperate need of loans that enable them to acquire the machinery and facilities for their livelihood. In the final analysis, this means equal access. We must focus on this idea if we are to seriously discuss reform in the credit system.

At the same time, we must be very cautious about creating a system which precludes the very smallest businesses from attaining credit. By setting a threshold that is too high, we prevent these people from building the enterprises that they are capable of building. Ultimately, this means depriving them of the spirit of American free-enterprise that we so often hear of.

Again, thank you Mr. Chairman for your efforts in holding these all important hearings.

OPENING STATEMENT OF RONALD K. MACHTLEY
COMMITTEE ON SMALL BUSINESS
HEARING ON CREDIT AVAILABILITY FOR SMALL BUSINESSES
APRIL 29, 1993

Thank you Mr. Chairman. And thank you gentlemen for appearing today to testify on credit availability for small businesses.

Not long ago, President Clinton outlined an initiative which would reduce the regulatory burden on banking institutions in hopes of increasing credit availability to small businesses. I commend the Administration for taking these important first steps to easing bank lending practices.

However, I hope that the President realizes that the program he announced last March is really just a jumping off point. Provisions in the Federal Deposit Insurance Corporation Improvement Act (FDICA) and the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) have forced banks to be even more cautious about lending. Given the new capital reserve requirements under FDICA, some banks may not even be able to stay in business. Based on evidence provided by the FDIC, and the Office of Thrift Supervision, there are plans to close more than 120 banks and roughly 80 thrifts over the coming year. In the past year, Rhode Island's fourth and fifth largest financial institutions have closed: Old Stone Bank with 1.9 billion in assets and Eastland Savings Bank with $550 million in assets. So, although I admire the President's support of easing regulatory restrictions, we desperately need to take further action.

Even though the economy shows signs of recovery, without comprehensive banking regulation reform, the problem of the credit crunch will not end soon. Legislation, such as the Economic Growth and Financial Institutions Regulatory Paperwork Reduction Act of 1993, would increase the amount of credit available to small and medium sized businesses by alleviating the banking industry of regulatory micromanagement. This proposal represents a comprehensive approach to promoting economic growth and eliminating regulatory red tape without threatening the soundness of the nation's financial institutions. By minimizing the government's role in regulatory oversight, this legislation would help ease the credit crunch that small businesses are still experiencing.

Another idea that I support, which is gaining steam in Congress and the Private sector, is the creation of a secondary market for small business loans. The sale of securities by the private sector, which are backed by small business loans, would create a strong secondary market benefiting bankers, small businesses and investors. In 1984, regulatory impediments to selling securities were removed from the housing industry through the formation of a secondary market which pooled residential

mortgages. Creating such a market for small business loans would encourage capital investment rather than discouraging it under current regulations.

In talking with small business owners across the state of Rhode Island, I have found that, in many cases, small firms interested in expansion or in need of working capital have been turned down by the banks. When asked why lending is so tight, banks indicate that laws and regulations prevent them from providing small businesses with long-term capital.

What kind of message are we sending our nation's small businesses when they read in the newspapers that many big banks loan millions of dollars to countries in South America -- loans that are not even repaid. What kind of message are we sending when these same banks lend large sums of money to foreign countries simply to help them repay the interest on their previous loans? How can my colleagues and I go back to our districts and explain to small business owners that big banks perform all sorts of foreign lending but can't give a local small business a loan?

If we are genuinely concerned about small businesses acquiring the credit they need to fuel our economy, it is clear that we have to take immediate action to reduce regulatory micromanagement. I believe that it would be penny wise and pound foolish to neglect the financing needs of small firms at a time when Rhode Island, and the rest of the nation, desperately needs the jobs and economic development small businesses generate. Thank you, again, gentlemen for coming before us today to address the effects future government policies will have on small businesses. I look forward to hearing your testimony.

Opening Statement
Of The
Honorable Cleo Fields
Before the
Committee on Small Business
Thursday, April 29, 1993 8:45 A.M.

Mr. Chairman, I am very happy that our panelist have come today to discuss the issue of credit availability. The problem most American communities face is a lack of credit availability and subsequently very little access to capital. I am in strong support of increased lending to small and medium sized businesses. As well as reducing some of the red tape in acquiring credit. I am also concerned with some of the

discriminatory practices by Banks in their disproportionate disbursement of credit. Hopefully our efforts today will lead to the introduction of some meaningful legislation in hopes of insuring that the aforementioned practices are curtailed. I welcome you to the Committee on Small Business and I look forward to hearing your testimony.

OPENING STATEMENT OF
THE HONORABLE
WALTER R. TUCKER II

I AM VERY HAPPY TO BE HERE WITH MY COLLEAGUES TODAY TO LISTEN TO THIS VERY TIMELY TESTIMONY FROM THE FEDERAL REGULATORS OF BANKS AND THRIFTS: THE OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE FEDERAL DEPOSIT INSURANCE CORPORATION, AND THE OFFICE OF THRIFT SUPERVISION. AS WE ALL KNOW SMALL BUSINESSES ARE NOT ONLY FACING A SEVERE CREDIT CRUNCH BUT NOW A KEY SBA LOAN PROGRAM HAS RUN OUT OF MONEY MAKING IT EVEN MORE DIFFICULT FOR SMALL BUSINESSES TO RAISE THE CAPITAL THEY NEED TO OPERATE, EXPAND, AND CREATE JOBS. THE PRESIDENT HAS

ANNOUNCED AN INITIATIVE TO INCREASE THE FLOW OF CREDIT TO SMALL BUSINESSES. I AM VERY INTERESTED TO HEAR HOW THE REGULATORS OF THAT CREDIT INTEND TO HELP WITH THAT FLOW OF CREDIT THAT IS SO BADLY NEEDED BY SMALL BUSINESSES.

NYDIA M. VELÁZQUEZ
12TH DISTRICT, NEW YORK

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OPENING STATEMENT, SMALL BUSINESS COMMITTEE
CONGRESSWOMAN NYDIA VELAZQUEZ
APRIL 28, 1993

Thank you Mr. Chairman. I would like to welcome the witnesses today's Small Business Committee hearing on the regulatory and administrative changes announced last month by President Clinton to ease the credit crunch on small business. We are honored that you can be here with us today.

As the Chairman stated, I am delighted at the emphasis that President Clinton has placed on small business as a means to economic recovery. He recognizes the potential of small business to generate jobs, particularly in some of our most starved urban communities. As we all know, the President has already eased bank regulations in order to provide small business with the capital necessary to strengthen their economic base. Now that the President's stimulus package, which included funding for the Small Business Administration's guaranteed loan program, has been killed in the Senate, we must ensure that we develop other means to provide loans to those who wish to start or expand their businesses.

I look forward to everyone's testimony. Thank you.

STATEMENT BY CONGRESSMAN JIM RAMSTAD
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
April 28, 1993

HEARING ON CREDIT AVAILABILITY FOR SMALL BUSINESSES

Mr. Chairman, I welcome the opportunity to discuss the critical issue of credit availability for small businesses with this morning's distinguished witnesses.

As a member of both the Small Business and Joint Economic Committees, I am keenly aware of the importance of small businesses to our economy -- and the problems they have faced in recent years in gaining access to credit.

The effect of tight credit is particularly hard on small businesses, which, unlike larger companies, do not have easy access to the debt and equity markets. Because they have no alternative financing avenue, when small businesses face tight credit, the result is devastating to the entire economy.

Small businesses, as we all know, are the real engine of job growth in our economy. In recent years, 85% of all new jobs in this country were created by small businesses, and in fact between 1988 and 1990, small businesses created all of the net new jobs in this country, according to the Small Business Administration (SBA).

Now that President Clinton has announced his proposal to impose the largest tax increase in history, the availability of credit for small businesses will be an even more urgent concern. As most economists agree, President Clinton's proposal to transfer $328 billion from the productive, private sector to the federal government will certainly constrict economic growth and reduce the availability of capital.

At a time of economic sluggishness, it is clear that enacting the largest tax increase in American history will have dire consequences for the jobs-producing, small business sector of our economy.

I have two informal advisory groups in my district -- a banking advisory group and a small business advisory group. In recent months, I could have combined the two meetings as both the small business owners and the bankers are concerned almost exclusively about the lack of credit, or the "credit crunch."

I recently visited a bank in my district and reviewed the administrative procedures required by banking regulatory agencies. I was truly stunned by the excessive paperwork -- which translates into added costs for consumers -- necessary for approval of just a simple loan.

This personal experience leads me to believe -- and I'm sure today's witnesses will agree -- that a very significant contributor to the "credit crunch" is excessive bank regulations.

And as today's witnesses are well aware, a recent study commissioned by the banking oversight agencies estimates that regulatory costs to the banking industry in 1991 were between $7.5 and $17 billion.

According to one industry analyst, in 1980, there was one regulator for every three banks -- by the end of this decade there will be more than three regulators for each bank. And for the first time in 27 years, banks now hold more government securities than business loans.

(MORE)

Clearly, excessive regulations combined with the regulatory bias that encourages banks to hold government bonds rather than commercial loans has contributed to the sluggishness of our economic recovery.

I also read with great interest a story in the March 18 Wall Street Journal about the skepticism with which most community banks -- which make the majority of loans to small businesses -- greeted President Clinton's plan to spur lending.

According to a survey by the Western Independent Bankers group, three out of four bankers from nine Western states said they had "little or no confidence" the president's plan would lead to more lending.

Mr. Chairman, I am extremely concerned. Although I understand that Treasury Secretary Bentsen has said that the Administration has not released the entirety of its proposal -- with the full program due June 10 -- I fear it is not enough.

In the same article I mentioned before, William Isaac, former head of the Federal Deposit Insurance Corp., said "I don't think the Administration has a prayer of changing it" -- referring to the regulatory environment caused by the 1989 and 1991 banking bills.

As the article continues, "President Clinton hasn't proposed legislation to do away with or change many of the rules that bankers say have multiplied the documentation required for a bank to make loans."

In this truly chilling atmosphere for our economy and for the credit-starved sector of our economy, I trust that today's witnesses will provide substantive insights into how President Clinton's regulatory relief proposals -- which appear to me to be a needed first step toward the regulatory relief we need -- will ease the burden on our banks and small businesses and address the resulting credit crunch.

I look forward to today's testimony.

For Release Upon Delivery
April 29, 1993, 8:45 a.m.

TESTIMONY OF
EUGENE A. LUDWIG
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
April 29, 1993

Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss credit availability for small businesses and the steps that President Clinton and the Office of the Comptroller of the Currency (OCC) are taking to encourage bank lending. Small businesses rely heavily on commercial banks as a source of funds for operating capital and expansion. As the supervisor of national banks, the OCC is committed to expanding the flow of credit while maintaining a safe and sound banking system.

To that end, we, along with the other federal financial regulators, are implementing the President's program of regulatory changes to improve credit availability for small- and medium-sized businesses, farms, and low-income and minority borrowers and communities. The program addresses concerns that regulatory practices may be contributing to an environment in which bankers are discouraged from making sound loans. It is designed to ensure that, as the economy improves and loan demand expands, banks are able to take full advantage of increased loan opportunities without unnecessary regulatory impediments.

We have already begun to implement several parts of the program, and we plan to complete the remaining changes within the next few months. On March 30, the agencies put into effect the first element of the President's program: a new policy to reduce documentation requirements for loans to small- and medium-sized businesses and farms. The OCC is preparing specific guidance for examiners regarding those changes. We are also simplifying and clarifying the regulations governing national bank treatment of foreclosed real estate (Other Real Estate Owned, or OREO), and expanding the options that national banks may use to dispose of OREO. We are also reducing appraisal requirements for small-business loans secured by real estate.

The first part of my statement discusses the problems of small businesses in obtaining bank loans. The second section describes the President's program to increase credit availability. The third section discusses the recent shift in bank portfolios from loans to securities, and the factors that have contributed to that shift.

I. **Credit Availability for Small Businesses**

After rising throughout the 1980's, total lending by national banks has fallen by $85 billion, or 6.7 percent, during the past two years. Two categories of loans have accounted for most of the decline: commercial and industrial loans, and real estate construction loans. The decline has been most pronounced in those regions of the country that are recovering most slowly from the recession, but it has been felt in all parts of the country.

Some of the decline in loan volume is due to weak loan demand and structural changes in the banking industry, which I will discuss later in this statement, but some of the decline undoubtedly reflects tighter lending standards. Bank managers and their supervisors have increased their emphasis on detailed financial data in assessing the creditworthiness of borrowers and the adequacy of loan collateral. This was a natural response to the credit underwriting excesses of the 1980's, but it has made banks more cautious about making loans. There has also been a decline in the availability of credit from troubled banks that are seeking to work out bad loans and rebuild capital.

Although federal banking agencies do not collect data on loans by size of borrower, we believe that small businesses have experienced greater problems with credit availability than have larger borrowers. That conclusion is supported by the limited information available from industry surveys[1]. Unlike large publicly traded firms, small businesses typically do not have

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[1] While some of the following surveys were based on limited samples and on methodologies that are not fully disclosed, they provide some support for anecdotal evidence that small businesses have been particularly affected by problems of credit availability.

- o Sixty percent of respondents to the January 1993 Federal Reserve Senior Loan Officer Opinion Survey believed that banking legislation and regulation had a disproportionate effect on lending to small business.
- o A December, 1992 paper published by the National Federation of Independent Business found a concentration of credit availability problems in larger small firms (40+ employees), where owners borrow relatively large amounts frequently, as opposed to smaller firms (less than 10 employees), which demand less credit.
- o A July 1992 study by Arthur Anderson and National Small Business United found that nearly half of all small business owners tried to get bank loans in the past year, and nearly one of every four applicants was turned down.

audited financial statements; and their income streams can be less predictable. This makes it more costly for them to supply the financial data required by bank managers and their supervisors. Small businesses are also less likely than large vertically or horizontally integrated firms to have many assets that can be pledged as loan collateral. Finally, small loans generate smaller profits, in dollar terms, with which to support the increased cost of loan administration.

Small- and medium-sized businesses play a critical role in the growth of the economy, contributing disproportionately to growth in jobs and productivity. Unlike large, publicly traded corporations, which have other sources of financing, such as the market for commercial paper, small businesses rely heavily on bank loans to obtain operating capital and financing for expansion. Bank loans also play an important role in financing small business start-ups, a key ingredient to the revitalization of economically distressed communities. Even profitable small businesses with excellent credit histories may find it difficult to succeed when they cannot get credit because of the economic and regulatory climate.

II. The President's Program

On March 10, President Clinton announced a program of regulatory and administrative changes directed at improving the flow of credit, particularly to small- and medium-sized businesses and farms. The OCC, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision jointly issued a policy statement that describes the steps we will take to implement the program.

The President's program includes initiatives in five areas: lending to small- and medium-sized businesses and farms, real estate lending and appraisals, appeals of examination decisions and complaint handling, examination processes and procedures, and paperwork and regulatory burden.

Lending to small- and medium-sized businesses. On March 30, the agencies released an interagency policy statement to eliminate unnecessary documentation requirements for loans to small- and medium-sized businesses and farms. Under the new guidelines, well-managed banks that are well- or adequately-capitalized will be permitted to make and carry a basket of loans to small- and medium-sized businesses and farms with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital, subject to a maximum loan size of $900,000 or 3 percent of the bank's total capital, whichever is less.

Eligible banks will be encouraged to make these loans based on their own best judgment as to the creditworthiness of the borrower and the necessary documentation. Examiners will

evaluate the loans solely on the basis of performance, and the loans will be exempt from examiner criticism of documentation. These changes should reduce the cost to banks of making small- and medium-sized business loans, and should also reduce the time that banks need to respond to credit applications from small- and medium-sized businesses.

The agencies also plan to clarify the examination and rating procedures relating to the Other Assets Especially Mentioned category of loans so that such loans are not improperly grouped with classified loans.

Appraisals and real estate lending. Because small businesses often have few tangible assets, their owners frequently secure their loans with mortgages on their places of business or their homes, even though the source of repayment is the cash flow from the business. Under current regulations, if such a loan is for an amount greater than $100,000, the lender must obtain an appraisal from a licensed or certified appraiser for the property securing the loan. This requirement may make such loans unprofitable for the lender to make.

Accordingly, as the President announced on March 10th, the banking regulators are considering ways to reduce the number of real estate-related transactions that require the services of an appraiser and simplify the preparation of appraisals for federally-related transactions. The agencies believe it is possible to reduce the number of required appraisals without increasing risk. We intend to clarify and amend existing exceptions to appraisal requirements, identify additional circumstances where appraisals are not required, and change existing requirements governing appraisal content and appraiser independence.

The OCC is also preparing to publish revisions to its Other Real Estate Owned (OREO) regulation (12 C.F.R. 7.3025) that will reduce appraisal requirements for real estate securing small- and medium-sized business loans. The changes will: (1) increase and expand the options that a national bank may use to dispose of OREO, (2) eliminate the inconsistencies in current OREO appraisal requirements, (3) remove conflicting OREO accounting guidance from the current regulation, and (4) provide other miscellaneous guidance.

In addition, the agencies will review in-substance foreclosure rules, and reiterate that loans secured by real estate should be evaluated based on the borrower's ability to pay over time, rather than on liquidation value.

Appeals and complaints. Under the new program, each agency will take steps to ensure that its appeals processes is fair and effective. In particular, each agency will ensure that its appeals process provides a fair and speedy review of examination complaints, and that there is no retribution against either the

bank or the examiner as the result of an appeal. At the same time, we are reviewing the processes we use to handle more general complaints from the public and from banks, to improve the care with which we review complaints and the timeliness of our responses. We are creating a position for a senior official, reporting directly to the Comptroller, whose sole responsibility will be to oversee the appeals process at the OCC.

Examination Process and Procedures. The President's program aims to minimize costs that the examination process imposes on regulated institutions. In particular, the agencies will eliminate duplication in examinations by multiple agencies, unless clearly required by law; increase coordination of examinations among agencies when duplication is required; and establish procedures to centralize and streamline examination in multi-bank organizations.

Continuing Further Efforts and Reducing Burden. The agencies will work to develop common standards for determining when delinquent loans that have been partially charged off may be returned to accrual status. The agencies will continue to review all paperwork requirements to eliminate duplication and review all regulations and interpretations to minimize burden while maintaining safety and soundness standards.

As part of this effort, the OCC is implementing an outreach program to facilitate communication between community bankers and examiners in the field. Under the program, examiners in each OCC district will hold regular meetings with small groups of bankers to discuss issues of current concern.

In addition, the agencies plan to consider carefully the process they use to examine compliance with the Community Reinvestment Act. The Administration wants to improve credit availability for small businesses operating in low- and moderate-income neighborhoods.

These measures are part of the Administration's broader effort to ensure equal credit opportunity for all Americans. Each agency will improve its examination procedures to detect illegal lending discrimination. Examiners will use new procedures, starting with an off-site review of the banks' application records, to identify anomalies that may indicate possible illegal discrimination.

As we carry out the President's programs and observe their effects, we will assess the extent to which problems of credit availability and regulatory burden stem from statutory mandates. We do not have recommendations for specific statutory changes at this time.

III. Trends in Bank Lending and Investment Securities Holdings

As loan holdings have declined over the past two years,

national banks have increased their holdings of investment securities--particularly short- and medium-term Treasury securities and mortgage-backed securities. Investment securities now constitute 20 percent of national banks' assets--more than their total holdings of commercial and industrial loans.

Some industry observers, noting that investment securities holdings have risen at about the same rate that lending has fallen, have suggested that both movements have been the result of changes in the regulatory environment. A closer look at the data reveals that there is no single cause for the shift from loans to securities.

Part of the shift can be explained by short-run economic factors. When economic growth slows, attractive lending opportunities shrink, and the securities markets provide an attractive place for banks to invest. As the economy recovers, this process reverses--as we can observe from recent reports of increased loan demand.

But part of the decline in bank lending is due to structural changes in financial markets that have reduced the banking industry's role as a provider of short-term credit. Although the volume of bank lending can be expected to rebound as the economic recovery continues, it will be difficult for the banking industry to recover all of the lending business that it has lost over a longer period to the commercial paper market, to finance companies, and to foreign lenders.

And part of the decline is undoubtedly due to changes in government oversight of bank lending. Changes in banking laws and supervisory practices, motivated in large part by the desire to reduce the risk of loss to the federal deposit insurance system, may have increased the cost of lending and contributed to an atmosphere in which bankers--often for good reasons--are more cautious about making loans.

As you know, we believe the President's program will go a long way toward alleviating this part of the problem.

Economic Factors

Profitability of Loans versus Securities

When banks evaluate their investment decisions, such as whether to purchase securities or make loans, they consider the relative return they can expect to receive from the two alternatives. The lower operational cost of holding securities, coupled with the high loss rates experienced recently on commercial loans (which decrease the expected return to bank lending), has made buying investment securities an attractive alternative to making loans of equal maturity. We estimate that during most of 1992, banks could expect to receive a slightly higher risk-adjusted return on equity from the purchase of one-

year Treasury securities than from one-year corporate loans. The advantage becomes much more pronounced when medium-term Treasury securities are compared with short-term commercial loans, due to the large spreads between short-term and medium-term yields in recent years.

Banks Increased Demand for Liquidity

When economic activity slows, individual depositors are more likely to withdraw funds, increasing banks' need for liquidity. In addition, payments on bank loans are often interrupted or delayed, and secondary markets for bank loans tend to become less liquid. Banks tend to respond to these changes by increasing their holdings of more liquid investment securities.

Not all of the increase in securities holdings represents a shift away from lending to the private sector. More than half of the total increase in national banks' securities holdings consists of mortgage-backed securities, which are securitized home mortgage loans. National bank holdings of mortgage-backed securities increased by $53 billion over the past two years, to $178 billion, or 8.9 percent of bank assets. Investing in mortgage-backed securities enables banks to provide credit indirectly to home buyers while also increasing balance sheet liquidity.

Cyclically Weak Loan Demand

A significant portion of the decrease in short-term bank lending stems from cyclically weak loan demand. During periods of slower economic growth, fewer profitable opportunities for business start-ups or expansion are available. Firms are less willing to invest in capital improvements or to increase their inventories. Consequently, the demand for short-term credit, including bank credit, declines. Furthermore, those businesses that do seek credit have less financial capacity to service their loans (since sales volumes are down) than they would during periods of full employment. Thus, during a recession, banks tend to receive fewer loan applications, and potential loan applicants tend to be, on average, less creditworthy.

We expect bank lending will increase as the economy continues to expand and as individual real estate markets continue to recover. The improvement in lending statistics for the fourth quarter of 1992 may already reflect improved economic conditions.

Structural Changes

The demand for bank loans--and for commercial and industrial loans in particular--has also declined as the result of long-term structural changes in the banking industry. In 1952, commercial banks issued 89 percent of all short-term debt; today, their share is only 58 percent.

Part of that decline reflects the substitution of commercial paper for bank loans. The percentage of short-term debt financed by commercial paper has increased from 1.4 percent to 11.7 percent since 1952. Large corporations that have excellent credit ratings can raise funds more cheaply through the commercial paper market than by borrowing from banks, many of which have lower credit ratings. Consequently, it is unlikely that the loan departments of commercial banks will be able to regain all of the business they have lost to the commercial paper market.

U.S. banks have also lost business to foreign lenders and finance companies. Foreign lenders, who had virtually no share of the U.S. market in 1952, now provide 8.3 percent of short-term credit in the United States (although they appear to have been pulling back in the last year or so). This trend reflects the internationalization of credit markets and is unlikely to be entirely reversed.

Finance companies have increased their share of short-term credit from 5.8 percent to 16.5 percent since 1952. The reasons for this shift, and whether banks can recover the business they have lost to finance companies, are less clear.

I believe that these trends are part of a broad change in the credit culture of commercial banks. Banks are under more and more pressure to improve their financial performance, in order to compete for the business of increasingly price-sensitive customers and investors, and to maintain their place in a rapidly consolidating banking industry. They also face increased competition from foreign banks and from non-bank providers of financial services. Banks are therefore placing greater emphasis on asset yields and fee income.

Bank Supervision

The recent recession, and the overbuilding of commercial real estate markets in many parts of the country, have impaired the quality of many banks' loan portfolios. In response, bank examiners have increased their criticism of loans and required banks to make larger additions to their loan loss reserves in order to reflect reduced credit quality. To try to make certain that bank examiners do not overreact to past problems, we are making every effort to communicate to banks that we do not want to discourage them from making good loans to creditworthy borrowers.

Conclusion

Bank supervision is not the only, and probably not even the most significant, cause of reduced credit flows, but it has undoubtedly raised the cost of lending and, to some extent, reduced the supply of bank loans. One of my priorities as Comptroller of the Currency--along with eliminating illegal

discrimination in banking services--will be to improve the flow of credit, particularly to small- and medium-sized businesses. We do not want bankers to make changes in their credit decisions based upon fear of unwarranted criticism by bank regulators, and we do not want to impose unnecessary regulatory impediments to sound lending. Commercial lending is a cornerstone of banking, and we continue to urge bankers to make sound loans to qualified borrowers.

But a critical part of the OCC's mission is to ensure that national banks follow sensible credit standards when they make loans, so that the national banking system can remain safe and sound. It is not in the public interest for us to look the other way when we uncover unsound credit practices or bad loans. If supervisors ignore problems, then actions to solve those problems will not be taken, and the situation will continue to deteriorate.

I believe the President's program strikes the proper balance between expanding credit availability and maintaining safety and soundness. This concludes my formal testimony. I will be glad to answer any questions.

72-212 O - 93 - 3

TESTIMONY OF

ANDREW C. HOVE
ACTING CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

CREDIT AVAILABILITY FOR SMALL BUSINESS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

8:45 AM
APRIL 29, 1993
ROOM 2359-A, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman and Members of the Committee, I am pleased to have this opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on credit availability for small businesses. As we are all well aware, small and medium-sized businesses are the engines of job growth in our economy. Since they generally have very limited or no access to public credit markets, it is critically important that these businesses have adequate access to bank credit on reasonable terms and conditions.

My testimony today will discuss the FDIC's active participation in a program of regulatory and administrative changes to stimulate bank lending to small businesses, the progress of the financial regulatory agencies in identifying possible statutory changes that may be appropriate, and recent trends in lending and investing in government securities by financial institutions.

Credit Availability

The banking industry is well positioned to increase lending to borrowers of all types, including small businesses. At the end of 1992, 11,361 or 95.8 percent of all BIF insured banks qualified as well capitalized. These banks held 87.3 percent of all assets of BIF insured institutions. An analysis by our research staff reveals that these well capitalized banks have sufficient capital to support asset growth approximating $500 billion and still meet the minimum capital requirements for well capitalized institutions. While we would not advocate that banks operate at minimum capital

levels and we recognize that any asset growth would include a mix of cash and other liquid assets as well as loans, a figure of that magnitude demonstrates that there is considerable untapped lending capacity in the banking system that is not constrained by regulatory capital requirements. This analysis, moreover, ignores securities holdings of well capitalized banks which could be readily liquidated to further increase lending. In short, the banking industry has ample liquidity and is in a position to lend.

Despite this capacity in the system, lending to businesses has lagged. Data on small loans to businesses, which will represent a reasonable proxy for small business lending, will become available beginning with the June 30, 1993 Call Reports. At present, therefore, we must rely on aggregate commercial and industrial (C&I) lending as reported by banks on their Call Reports.

These data, which may reflect lending predominantly to larger borrowers with lower cost funding alternatives, show that commercial and industrial lending by banks has steadily declined for eleven consecutive quarters, from the second quarter of 1990 through the fourth quarter of 1992. C&I loans to U.S. borrowers, which represent about 86 percent of all C&I loans, declined throughout this period, with the exception of a slight increase in the last quarter of 1992. Over the three-year period 1990 to 1992, C&I loans were down about 14 percent. Most of the decline has occurred in areas of the country where economic conditions have

been most adverse, i.e., Northeastern states and California.

We believe this decline is attributable to a number of factors. Much of the decline reflects slack demand resulting from the 1990-91 recession and the slow pace of recovery. The normal reaction of businesses in these times, particularly small businesses, is to shore up their balance sheets by conserving cash and reducing borrowing. Often, they will await an upturn in business or prospects before committing to additional borrowing to finance working capital needs, expansion and capital expenditures.

Call Report data on commitments to make C&I loans[1] support this analysis. These commitments have remained quite stable over the last two years as outstanding loan balances have declined. From the first quarter of 1991 through the fourth quarter of 1992, C&I loans declined $69 billion (11.5 percent), while C&I loan commitments declined less than $3 billion (0.5 percent). This indicates intent and willingness on the part of banks to make C&I loans, but borrowers are opting not to draw down these funds, despite having paid fees to secure the commitments.

In addition, banks generally have strengthened their underwriting standards in the aftermath of the excesses and losses

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[1]C&I loan commitments are reported on Schedule L under "Other Unused Commitments," which for most banks will consist predominantly of C&I loan commitments.

of the 1980s. Many banks are continuing to work off troubled assets and have learned some difficult lessons. Consequently, they are more selective and hesitant to finance new businesses or the expansion of established businesses without a substantial commitment of equity from the borrower and a demonstrated repayment record. Borrowers who cannot meet the more selective criteria are having a particularly difficult time in obtaining bank credit, which may help explain some of the growth in commercial lending by finance companies. Real estate, which has traditionally served as side collateral for many small business loans, has either declined in value in many parts of the country or is not appreciating as rapidly as in the past. Consequently, the equity commitment is more difficult to satisfy for many small businesses.

Credit Availability Program

On March 10, the FDIC joined the Office of the Comptroller of the Currency, Office of Thrift Supervision and Federal Reserve Board in issuing a statement on the problems of credit availability, especially for small and medium-sized businesses and farms. This program, which is set forth in detail in Attachment A, focuses on five areas in which the federal regulatory agencies will act to alleviate the apparent reluctance by banks and thrifts to lend. Those areas are:

- Lending to Small and Medium-Sized Business and Farms
- Real Estate Lending and Appraisals
- Appeals of Examination Decisions and Complaint

Handling

- Examination Processes and Procedures
- Paperwork and Regulatory Burden.

The agencies intend to complete virtually all of the changes proposed in the program within the next few months. Each proposed change will be published individually as the specifics of the change are finalized.

On March 30, the banking agencies announced a joint policy statement on documentation of loans, which is included as Attachment B. Under this new policy, the strongest banks and thrifts, i.e., those which are rated CAMEL or MACRO 1 or 2 and which are at least adequately capitalized, are now able to make and carry some small and medium-sized business and farm loans with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital. Eligible banks and thrifts will be encouraged to make these based on their own best judgment as to the creditworthiness of the borrowers and necessary documentation. These loans will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation.

Agency staff are hard at work devising implementation strategies for the remaining elements of the Administration's program. The next element to be released will likely be a proposed revision of the agencies' appraisal regulations which will be

designed to limit the need for formal appraisals prescribed by regulation in a variety of circumstances. This should simplify and facilitate the credit granting process by reducing the cost and delays associated with providing real estate as collateral without compromising essential safety and soundness concerns.

It is impossible to quantify the additional credit that may be extended as a result of the program since we are still rather early in the implementation stage and it would be extremely difficult to isolate the additional lending attributable to the program. We are confident, nevertheless, that the initiatives will prove very helpful in eliminating unwarranted impediments to small business lending and opening new opportunities which both banks and small businesses can reasonably be expected to use to good advantage.

<u>Statutory Changes</u>

As a follow-up to the report on regulatory burden submitted to the Congress last December, the agencies noted that much of the burden imposed on depository institutions derived from statute and consequently there was little the agencies could do on their own to relieve that burden. Consequently, the agencies undertook to identify for Congress possible statutory changes designed to reduce regulatory burden and to report their proposals to Congress by late Spring. Thus far, agency staff have identified for review by senior management at each agency possible statutory changes which the agencies may choose later to recommend to Congress. The review

process is still ongoing and the agencies have reached no firm conclusions.

We should point out, however, that the focus of this effort is the reduction of regulatory burden and not increasing credit availability per se. The relationship between burden reduction and credit availability is often indirect and difficult to measure. Any cost savings resulting from a reduction in burden may be used in a variety of ways other than funding additional lending. If cost savings are passed on to borrowers by way of lower interest rates and loan fees, loans may become affordable for more borrowers. This would improve credit availability although the result would be very difficult to isolate and measure.

The goal of eliminating unnecessary and burdensome requirements, whether statutory or regulatory, is a worthy one in and of itself and one which must be pursued. Any success in reducing overall burden on banks would serve to reduce their costs and improve their competitive efficiency vis-a-vis other lenders and this will have a positive effect on credit availability, particularly over the longer term.

Government Securities Purchases

Banks have substantially increased their holdings of government securities over the past few years while their total loans have decreased. This shift to government securities reflects

both a reduced demand for loans and attractive returns on government securities resulting from an unusually steeply sloping yield curve. The spread between short and longer-term Treasury securities increased steadily since 1990 enabling banks to increase their profits by investing in medium-term instruments, with only moderate interest rate risk and lower costs than loans.

We do not view this investment shift to government securities as a long-term problem but rather as a temporary situation that will change as improving economic conditions bring about increased loan demand. Also, if short-term interest rates rise, the spread between deposits and securities will be closed and banks will no doubt seek higher-yielding investments, such as loans, in order to maintain margins and profits.

We would also note that approximately half of the increase in holdings of U.S. government securities is attributable to increased holding of residential mortgage-backed securities which permit banks to serve as an important indirect source of funding for home loans. Yet other securities holdings serve to finance student and small business loans.

This concludes my formal testimony. I would be pleased to respond to any questions the Members of the Committee may have.

EMBARGOED
until April 29, 8:45 am

TESTIMONY

of

Jonathan L. Fiechter

Acting Director

Office of Thrift Supervision

concerning

Credit Availability for Small Businesses

before the

Committee on Small Business

United States House of Representatives

April 29, 1993

Office of Thrift Supervision
Department of the Treasury

1700 G Street NW
Washington DC 20552
202-906-6288

Testimony of Jonathan L. Fiechter
Acting Director
Office of Thrift Supervision
April 29, 1993

INTRODUCTION

Good morning Mr. Chairman and members of the Committee. I am pleased to be here today to discuss the important role of savings and loans in meeting the credit needs of our nation.

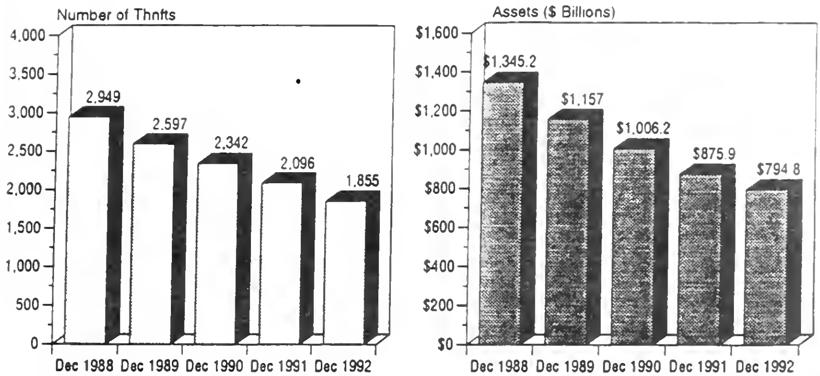
I will briefly review the traditional role of the thrift industry -- particularly since it differs from most other financial providers -- and discuss recent joint initiatives announced by the banking agencies to enhance credit availability.

THRIFTS -- MORTGAGE AND CONSUMER LENDERS

The primary purpose of savings associations, reaffirmed in the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"), is to be consumer-based institutions with a statutory emphasis on housing and consumer finance. Thrifts are fulfilling this mission.

But as you know, the industry has emerged from its recent crisis approximately one-third smaller than just 4 years ago. The number of thrifts declined from 2,949 institutions in December 1988 to 1,855 at the end of 1992. In the same period, industry assets fell from $1.3 trillion to less than $800 billion. That shrinkage in terms of institutions and assets is illustrated in the following chart.

THE INDUSTRY CONTINUES TO SHRINK IN NUMBER OF ASSOCIATIONS AND ASSETS



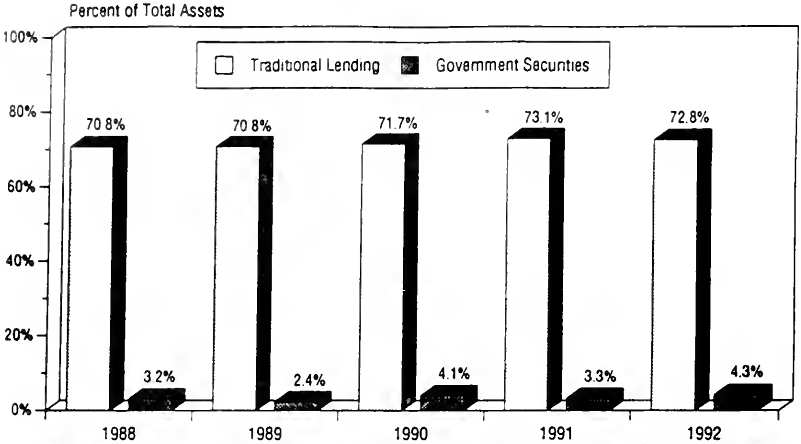
Office of Thrift Supervision / March 1993

Obviously, today's smaller thrift industry plays a lesser role in the overall credit granting function in our economy. Notwithstanding the significant transformation of the thrift industry, today's private sector savings associations remain active lenders.

Thrifts operating as of December 31, 1992, had 70% of their portfolios -- more than $560 billion -- in residential housing-related finance and consumer loans. For these institutions, this percentage has been remarkably constant over the last several years. Thrift investments in government securities are currently less than 5% of their portfolios, a level that has also been constant over the past several years.

The following chart depicts these trends over the past five years.

TODAY'S THRIFTS HAVE CONTINUED TRADITIONAL LENDING
(Associations held constant as of December 31, 1992)



Traditional lending includes 1- to 4-family mortgages, multifamily mortgages, mortgage pool securities, and consumer loans. "Held constant" includes only associations operating as of December 31, 1992. The nonviable institutions that have been transferred to the Resolution Trust Corporation are not included.

Office of Thrift Supervision / March 1993

Thrifts have experienced little growth in their asset base. Primarily due to the need to control interest rate risk and to keep capital-to-asset ratios high, thrifts have sold a large portion of their new loans. For instance, in 1992 thrifts sold 67% of their new mortgage loans into the secondary market. While thrift portfolios have remained relatively unchanged in recent years, thrifts have added slightly to their holdings of single-family home loans, multifamily home loans and consumer loans and reduced their holdings of commercial loans, commercial real estate loans and mortgage-backed securities.

The reduction in nonmortgage loans is to be expected. FIRREA's combination of generally higher minimum capital standards, the limitation on nonresidential real property loans, and stricter loans-to-one-borrower rules required thrifts to increase their capital while reducing their risk. The tougher Qualified Thrift Lender test mandated a refocus by thrifts on residential housing loans.

CREDIT AVAILABILITY INITIATIVES

Though the thrift industry has concentrated its lending

activities in the home mortgage and consumer finance areas, we are aware that not all of those credit needs are being met and that some thrifts are retreating from their traditional role in extending credit for single- and multifamily construction lending.

Over the past five years, thrifts in operation today have significantly reduced their underwriting of construction loans. For institutions operating as of December 31, 1992, total construction lending has decreased from over $23 billion in 1988 to under $12 billion in 1992, representing an almost 50% decline. This represents an overall decline in construction lending by thrifts from 2.8% of total assets to 1.5% of total assets.

Lending for nonresidential construction loans declined from over $7 billion in 1988 to under $1.4 billion in 1992. Multifamily construction lending declined from $4.6 billion in 1988 to $1.2 billion in 1992. These declines mean that today's thrifts are underwriting only 20% of the nonresidential and multifamily construction loans that the industry underwrote in 1988.

These figures are in sharp contrast to construction lending for single family homes. While there has been a decline in this lending -- from $11.5 billion in 1988 to $9.3 billion in 1992 -- it has been much more modest than in the other areas. Moreover, in 1992, thrifts actually increased their lending for single family construction from $8.7 billion in 1991 to $9.3 billion in 1992. I expect this trend to continue in 1993.

Given the importance to our economy of a vibrant housing market -- including multifamily buildings, where much of the nation's affordable housing stock is -- the Office of Thrift Supervision (OTS) is working to identify and, where possible, remove regulatory impediments to residential construction lending. In addition, we are evaluating ways we can do more to encourage thrifts to meet other credit needs in their communities, particularly housing for low- to moderate-income borrowers.

I assure you that as the primary thrift regulator, the OTS does not want its supervisory policies, or any misunderstandings that might arise from them, to interfere with savings associations' ability to make sound loans to creditworthy borrowers, especially when the loans are to finance housing. With this in mind, we are reviewing all of our supervisory policies and examination practices.

In addition, the Federal banking regulatory agencies have been working together, in conjunction with the Department of the Treasury, on actions to make more credit available.

The first initiative is directed toward small- and medium-sized businesses and farms. It allows well run, adequately capitalized banks and thrifts to create a "basket" of loans of up to 20% of capital. These loans will be evaluated solely on performance and will be exempt from examiner criticism of documentation. While bank and thrift management will remain responsible for the credit underwriting, credit quality assessment, and the determination of the appropriate loan loss allowance for these loans, the lending institution will not be subject to criticism for the documentation of these loans.

Secondly, we are reviewing the burdens imposed by current appraisal requirements and our examination process and procedures.

The OTS is considering creating an ombudsman position. This office would open up a direct line of communication with institutions outside of the formal examination process. We believe this initiative gives us a substantive response to criticism that our current appeals process is inadequate.

At this point I would like to say a word or two about examiners. FIRREA put examiners under heavy pressure to closely scrutinize banks and thrifts. Their response, in some cases, may have resulted in instances of overly restrictive examinations. This in turn probably caused some financial institutions to tighten credit.

The President's program is intended to encourage examiners to rely more on their experience and good judgment. The financial institutions' regulatory agencies are communicating this message to the industry and urging examination staffs to use their experience and good judgment in implementing the President's credit availability program.

In this regard, the OTS will hold a National Senior Examiners' Conference in Dallas, May 10-12. Approximately 250 OTS examiners and field managers from around the country will meet to discuss OTS' role in regulating a healthy thrift industry. A specific theme throughout the conference will be how the examiners' role is changing in the context of the improving thrift industry. Credit availability, community reinvestment and affordable housing will be major topics of discussion.

We anticipate changes will result from these undertakings that should allow credit to flow to help finance the economic recovery.

Beyond the efforts I have just described, the OTS is also working to identify other steps that would help free up credit without endangering safety and soundness. For

example, we are exploring expanding the authority of well-capitalized savings and loan holding companies to make noncontrolling investments in undercapitalized thrifts under the Qualified Stock Issuance (QSI) provisions of HOLA.

Let me cite an example of a recent success, under the current QSI provisions. Minority-owned Family Savings, a undercapitalized institution located in the south central LA area, was recapitalized through a QSI capital infusion of $1 million by the Robert Bass Group. That infusion not only restored the institution's financial health, it enabled Family to significantly increase its lending to predominately minority individuals in the south central LA area.

Family was also able to increase its presence in the community through the acquisition, at no cost to the Resolution Trust Corporation (RTC), of a small minority-owned thrift also located in south central LA and operating under RTC conservatorship. Family has been able to attract other investors, such as First Interstate and Walt Disney, who have each promised to infuse an additional $1 million. This institution is now playing a key role in rebuilding LA, a role that may not have existed but for the QSI. Expanding this authority will allow a greater opportunity to other minority institutions to experience the same positive transaction experienced by Family Savings.

RTC FUNDING

One final point I would like to make relates to how the lack of RTC funding is restricting credit availability.

The lack of funding for the RTC's resolution of conservatorships affects the availability of credit in communities where thrifts have been placed in conservatorships. The resolution of 85 thrifts at the RTC has been severely hampered by the lack of funding. Placement of a thrift in conservatorship often results in an unavoidable disruption in making credit available to borrowers who are dependent on funding from the institution for ongoing projects. Even borrowers with performing loans may find that renewals or obtaining credit under previous loan commitments are not forthcoming. Even more difficult is the restructuring of problem loans. For large problem loans, which may involve participations by other banks and thrifts, workouts become even harder to achieve.

Extended conservatorship -- due to the lack of RTC funding -- only exacerbates this problem. This is particularly troublesome for good borrowers who are looking to renew or refinance existing loans, but who find the institutions in conservatorship unwilling or unable to respond to their loan inquiries.

	Office of the Comptroller of the Currency
Joint Release	**Federal Deposit Insurance Corporation**
	Federal Reserve Board
	Office of Thrift Supervision

(PR-20-93)

Interagency Policy Statement on Credit Availability

March 10, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced a program directed at dealing with problems of credit availability, especially for small and medium-sized businesses.

The program will focus on the five areas in which the agencies will take action designed to alleviate the apparent reluctance by banks and thrifts to lend. Those areas are:

- Lending to Small- and Medium-sized Businesses
- Real Estate Lending and Appraisals
- Appeals of Examination Decisions and Complaint Handling
- Examination Processes and Procedures
- Paperwork and Regulatory Burden.

The agencies intend to complete virtually all of the changes proposed in the program within the next few months. As the specifics of any change are finalized, that change will be made and published while details of other changes are in the process of being finalized.

A complete statement about the actions the agencies have planned is attached. The statement reaffirms the agencies' belief that it is in the interest of lenders, borrowers and the general public that creditworthy borrowers have access to credit.

This policy statement will be distributed to all federally examined banks and thrifts and to all regulatory agency offices and examiners.

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Credit Availability

March 10, 1993

Problems with the availability of credit over the last few years have been especially significant for small- and medium-sized businesses and farms. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — recognize that in the last several years the buildup of certain regulations and practices has become overly burdensome. Indeed, those regulations and practices may have, in some cases, stifled lending, particularly to small- and medium-sized businesses that met prudent underwriting standards.

It is in the interest of lenders, borrowers, and the general public that creditworthy loans be made. Since economic growth, especially job growth, is fueled primarily by small- and medium-sized businesses, credit availability to those borrowers is especially important. Accordingly, the agencies are working on the details of a new program to help ensure that regulatory policies and practices do not needlessly stand in the way of lending. Loans to creditworthy borrowers should be made whenever possible, as long as they are fully consistent with safe and sound banking practices.

Background

The new program is one aspect of an overall effort by the agencies to evaluate carefully and react appropriately to risk in the United States financial services industry. That overall effort envisions substantial oversight, in some cases more than we have now, in areas that pose greater risk to the system. By the same token, regulatory burden will be reduced where risk is low, especially for strong, well-managed banks and thrifts. This program is also part of a broader effort to ensure equal credit opportunity for all Americans and to make credit and other financial services available to low- and moderate-income neighborhoods and disadvantaged rural areas.

The Program

The new program involves a variety of regulatory and other administrative changes which have been agreed to in principle by the agencies. These changes fall into five categories, each of which is discussed below.

Timing. The agencies will work to complete virtually all of the changes outlined below within the next three months. Once the specifics of any of the changes are agreed upon, that change will be made and published, while distribution of other changes remains to be made.

1. Eliminating Impediments to Loans to Small- and Medium-Sized Businesses

Reducing Documentation. Strong and well-managed banks and thrifts will be permitted to make and carry a basket of loans with minimal documentation requirements, consistent with applicable law. To ensure that these loans are made to small- and medium-sized businesses, there will be a ceiling on the size of such loans and limits on the aggregate of such loans a bank may make.

Encouraging Use of Judgment\Borrower's Reputation. The agencies will issue guidance to make it clear that banks and thrifts are encouraged to make loans to small- and medium-sized businesses, particularly loans in the basket discussed above, and to use their judgment in broadly assessing the creditworthy nature of the borrower — general reputation and good character as well as financial condition may be elements in making these judgments. Reliance on a broad range of factors when making a credit determination is especially important.

Other Assets Especially Mentioned. Improper use of the category of Other Assets Especially Mentioned (OAEM) may inhibit lending to small- and medium-sized businesses. Accordingly, the agencies will clarify that examination and rating procedures do not group OAEM loans with classified loans.

2. Reducing Appraisal Burden and Improving the Climate for Real Estate

The experience of the last decade has underscored the importance of sound underwriting standards and effective supervision for commercial real estate loans. Nonetheless, in certain instances regulatory burdens may be adversely affecting loans to sound borrowers. This may be particularly so in the case of loans secured by real estate that are primarily used for non-real estate business purposes. Real estate collateral is often pledged for loans to small- and medium-sized companies that have few other tangible assets.

Using Real Estate Appraisals Prudently. In some cases currently required real estate appraisals may not add to the safety and soundness of the credit decision. Indeed, in some cases, appraisals may prove so expensive that they make a sound small- or medium-sized business loan uneconomical. Accordingly, the agencies will make changes to their rules relating to real estate appraisals along the following lines:

- **Accept Additional Collateral**
  When real estate is offered as additional collateral for a business loan, both the time and expense involved in obtaining an appraisal from a certified or licensed real estate appraiser may discourage a bank or thrift from taking the collateral, may increase the cost of credit significantly, or even may cause the loan not to be made. In some such cases, the real estate appraisal requirement is counterproductive from a safety and soundness perspective. Moreover, the constraint on credit flows to sound businesses may be substantial. Accordingly, the agencies will alter their real estate appraisal rules so as not to require an appraisal by a licensed or certified appraiser for such loans.

- **Reexamine Appraisal Thresholds**
  Appraisals conducted by licensed and certified real estate appraisers, even on real estate of modest value can be quite costly. In the case of a smaller loan, the requirement of an appraisal by a licensed or certified real estate appraiser may make a sound loan uneconomical. Accordingly, the agencies will reexamine their existing rules to make certain that thresholds below which formal appraisals are not needed are reasonable.

- **Limit Periodic Appraisals**
  In some cases real estate appraisals have been required after a loan has been made, and in circumstances where the appraisal did not add to the safety and soundness of the loan. Accordingly, the agencies will work to make certain that real estate appraisals are required after a loan is made only when clearly needed for safety and soundness purposes, provided of course, that all requirements under law have been met.

Changing Rules on Financing of Other Real Estate Owned. Currently, accounting and other rules may discourage banks and thrifts from providing financing to borrowers who wish to purchase real estate classified as Other Real Estate Owned. The agencies will review rules relating to the reporting treatment and classification of such loans and make appropriate changes to facilitate financing to creditworthy borrowers, consistent with safe and sound banking and accounting practices.

Reviewing In Substance Foreclosure Rules. The inappropriate use of in substance foreclosure rules have required foreclosure valuation treatment of loans when borrowers were current on principal and interest payments and could reasonably be expected to repay the loan in a timely fashion. The agencies will work with the appropriate authorities to alter that treatment and to coordinate a change in accounting principles and reporting standards.

Avoiding Liquidation Values on Real Estate Loans. Loans secured by real estate should be evaluated based on the borrower's ability to pay over time, rather than a presumption of immediate liquidation. The agencies will work with their examination staffs to ensure that real estate loans are evaluated in accordance with agency policy.

3. Enhancing and Streamlining Appeals and Complaint Processes

Appeals. It is important for bankers to have an avenue by which they can obtain a review of an examiner's decision when they wish. For that reason, each of the agencies has established an appeals process. To ensure the effectiveness of those processes, each agency will take appropriate steps to ensure that its appeals process is fair and effective.

In particular, each agency will ensure that its process provides a fair and speedy review of examination complaints and that there is no retribution against either the bank or the examiner as the result of an appeal.

Complaints. Each of the agencies has a process to handle more general complaints from the institutions they regulate and from the general public. Although the volume of such complaints can be high, each agency recognizes that reviewing and responding to these complaints is an important element of proper supervision. The agencies are particularly concerned that complaints of discriminatory lending practices be handled with the utmost seriousness and on an expedited basis.

Accordingly, the agencies will review their complaint processes to improve both the care with which complaints are scrutinized and the timeliness of responses.

4. Improving Examination Process and Procedures

Reducing the Burden of the Examination Process. A proper examination of a bank or thrift by its very nature involves some disruption to the examined institution. Such disruptions, however, are costly to the institution and can interfere with its credit functions. It is highly desirable that examination disruptions be minimized.

Accordingly, the agencies have agreed to intensify efforts to minimize such disruptions and, in particular, to take the following steps: (i) eliminate duplication in examinations by multiple agencies, unless clearly required by law, (ii) increase coordination of examinations among the agencies when duplication is required, and (iii) establish procedures to centralize and streamline examination in multibank organizations.

Refocusing the Examination Process. If examinations are to fulfill their functions both in the areas of safety and soundness, fair lending, and consumer protection compliance, it is important constantly to reexamine the elements of the examination to determine whether the process is effective. Similarly, regulations and interpretations must continually be assessed to determine whether they are fulfilling these functions.

To improve the regulatory process, the agencies have agreed to heighten their emphasis in examinations on risk to the institution and to issues involving fair lending in place of areas that have become less productive over time. Agency policies and procedures will be reviewed with this focus in mind.

Reducing Regulatory Uncertainty. Uncertainty is part of the regulatory burden that banks and thrifts face and that contributes to their reluctance to make some credits available. This uncertainty can stem from ambiguous language in regulations and interpretations, from delays in publishing regulations and interpretations, and from failures to follow uniform examination standards that clearly reflect agency policies.

Accordingly, the agencies will review their regulations and interpretations to minimize ambiguity wherever possible and will step up efforts to publish regulations and interpretations required by law or sound regulatory practice. In addition, the agencies will reemphasize to their examiners to follow agency policies and guidelines carefully and accurately in carrying out examinations and reviewing applications. The agencies will make every effort to ensure that examination and application processing is performed uniformly across the country.

5. Continuing Further Efforts and Reducing Burden

Further Efforts. Additional items will be reviewed for possible change. One item that will be reviewed relates to the treatment of partially charged-off loans. Under current practice delinquent loans that have been partially charged off cannot be returned to

performing status even when the borrower is able to, and fully intends to, pay the remaining interest and principal to the bank in a timely fashion. The agencies will work to develop common standards for determining when a loan may be returned to accrual status.

Paperwork Burden. No good is served by forcing banks to bear an excessive regulatory paperwork burden. Accordingly, the agencies have begun and will continue to review *all* paperwork requirements to eliminate duplication and other excesses that do not contribute substantially to safety and soundness.

Regulatory Burden. It is not paperwork alone that unnecessarily burdens banks and thrifts. Regulations and interpretations also may be unnecessarily burdensome. In some cases the passage of time has made regulations outmoded. In other cases the regulations may not have fulfilled their goals.

Accordingly, the agencies also have begun and will continue to review *all* regulations and interpretations to minimize burden while maintaining safety and soundness standards.

Distribution: FDIC-supervised banks (Commercial and Savings)

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

(PR-26-93)

Interagency Policy Statement on Documentation of Loans

March 30, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced further details on the implementation of their March 10 program to increase credit availability. Today's policy statement outlines changes in the area of loan documentation.

The strongest banks and thrifts, those with regulatory ratings of 1 or 2 and with adequate capital, will now be able to make and carry some loans to small- and medium-sized businesses and farms with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital. Eligible banks and thrifts will be encouraged to make these based on their own best judgment as to the creditworthiness of the loans and the necessary documentation. These loans will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation.

Each minimal documentation loan is subject to a maximum loan size of $900,000 or 3 percent of the lending institution's total capital, whichever is less. If a borrower has multiple loans in the exempt portion of the portfolio, those loans must be aggregated before the maximum is applied. Loans to institution insiders — executive officers, directors, and principal shareholders — are ineligible for inclusion, as are loans that are already delinquent.

The package also offers some relief for banks that do not qualify for the program, and for loans that are not in the exempt portion of a bank's portfolio. The policy statement also includes guidelines which provide institutions some additional flexibility in applying their documentation policies for small- and medium-sized business and farm loans without examiner criticism.

Today's initiatives are directed at eliminating unnecessary documentation and reducing costs to lending institutions and the time it takes to respond to credit applications. OTS will soon issue a regulation to amend its current loan documentation requirements to comply with the statement. For banks, the program requires no change in existing regulations and is effective with today's release.

The complete program is being mailed to all regulated institutions and all examiners, and additional copies are available from the agencies.

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Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms

March 30, 1993

Introduction

Problems with the availability of credit over the last few years have been especially significant in the area of small- and medium-sized business and farm lending. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform, Recovery, and Enforcement Act and the Federal Deposit Insurance Corporation Improvement Act.

The four federal banking agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — expect small- and medium-sized business and farm loans, like all credits, to be made consistent with sound underwriting policies and loan administration procedures. The agencies are concerned, however, that institutions may perceive that the agencies are requiring a level of documentation to support sound small- and medium-sized business and farm loans that is in excess of what is necessary to making a sound credit decision. Unnecessary documentation raises the cost of lending to small- and medium-sized businesses and farms, results in delays in bank lending decisions, and may discourage good borrowers from applying. The agencies believe that the elimination of unnecessary documentation for loans to small- and medium-sized businesses and farms will reduce costs to the institution and the time it takes to respond to credit applications from small- and medium-sized businesses and farms without adversely affecting the institution's safety and soundness.

The federal banking agencies expect financial institutions to maintain documentation standards that are consistent with prudent banking policies. However, the maintenance of documentation beyond that necessary for a credit officer to make a sound credit decision and to justify that decision to the institution's management adds to loan administration costs without improving the credit quality of the institution. Unnecessary documentation impedes the institution from

responding in a timely and prudent manner to the legitimate credit needs of small- and medium-sized businesses and farms in its community. Accordingly, the agencies are taking steps to correct any misunderstanding of regulatory requirements and to reduce regulatory impediments to lending to creditworthy small- and medium-sized businesses and farms.

Documentation Exemption for Small- and Medium-sized Business and Farm Loans

Well- or adequately capitalized institutions with a satisfactory supervisory rating will be permitted to identify a portion of their portfolio of small- and medium-sized business and farm loans that will be evaluated solely on performance and will be exempt from examiner criticism of documentation. While bank and thrift management will retain responsibility for the credit quality assessment and loan loss allowance for these loans, the lending institution will not be subject to criticism for the documentation of these loans.

This exemption will be available only to institutions that are well- or adequately capitalized institutions under each agency's regulations implementing section 38 of the Federal Deposit Insurance Act and that are rated CAMEL or MACRO 1 or 2. These institutions are by definition those that have demonstrated sound judgment and good underwriting skills; moreover, their strong capital position insulates the deposit insurance funds from potential losses that may be incurred through small- and medium-sized business and farm lending.

To qualify for the exemption, each loan may not exceed the lesser of $900,000 or three percent of the institution's total capital, and the aggregate value of the loans may not exceed 20 percent of its total capital. In addition, loans selected for this exemption by an institution must not be delinquent as of the selection date, and each institution must comply with applicable lending limits and other laws and regulations in making these loans. Furthermore, such loans may not be made to an insider.

Small- and medium-sized business and farm loans that do not meet the criteria for exemption set forth in this policy statement would continue to be reviewed and classified in accordance with the agencies' existing policies.

The details of the exemption are as follows:

- **Documentation exemption.** Each institution eligible for the exemption provided in this policy statement may assign eligible loans, subject to the aggregate limit on such eligible loans, to an exempt portion of the portfolio. Loans assigned to this exempt portion will not be reviewed for the completeness of their documentation during the examination of the institution. Assignments of loans to the exempt portion shall be made in writing, and an aggregate list or accounting segregation of the assigned loans shall be maintained, including the performance status of each loan.

- **Restrictions on loans in the exempted portion of the portfolio.** The institution must fully evaluate the collectibility of these loans in determining the adequacy of its allowance for loan and lease losses (ALLL) or general valuation allowance (GVA) attributable to such loans and include this evaluation in its internal records of its assessment of the adequacy of its ALLL or GVA. Once a loan in the exempt portion of the portfolio becomes more than 60 days past due, the loan may be reviewed and classified by an examiner; however, any decision to classify would be based on credit quality and not on the level of documentation.

- **Eligible institutions.** An institution is eligible for the documentation exemption if (1) pursuant to the regulations adopted by the appropriate federal banking agency under section 38 of the FDI Act, the institution qualifies as well- or adequately capitalized, and (2) during its most recent report of examination, the institution was assigned a composite CAMEL or MACRO rating of 1 or 2.

- **Ineligible loans.** Loans to any executive officer, director, or principal shareholder of the institution, or any related interest of that person, may not be included in the basket of loans.

- **Aggregate limit on loans.** The aggregate value of all loans assigned to the basket of loans provided for in the exemption may not exceed 20 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency).

- **Limit on value of individual loan.** A loan, or group of loans to one borrower, assigned to the basket of loans provided for in the exemption may not exceed $900,000 or 3 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency), whichever is the smaller amount.

- **Transition from eligibility to ineligibility.** An institution that has properly assigned loans to the exempt portion of its portfolio pursuant to this statement but subsequently fails to qualify as an eligible institution may not add new loans (including renewals) to this category.

Treatment of Small- and Medium-sized Business and Farm Loans Not Qualifying for Exemption

The agencies will continue current examination practices with regard to documentation of small- and medium-sized business and farm loans at institutions not qualifying for the exemption and loans at qualifying institutions that are not assigned to the exempt basket. The guiding principle of agency review will continue to be that each insured depository institution should maintain documentation that provides its management with the ability to:

(a) make an informed lending decision and to assess risk as necessary on an ongoing basis;

(b) identify the purpose of the loan and the source of repayment;

(c) assess the ability of the borrower to repay the indebtedness in a timely manner;

(d) ensure that a claim against the borrower is legally enforceable; and

(e) demonstrate appropriate administration and monitoring of a loan.

In prescribing the documentation necessary to support a loan, an institution's policies should take into account the size and complexity of the loan, legal requirements, and the needs of management and other relevant parties (such as loan guarantors).

In applying these standards, the agencies will continue to recognize the difficulty and cost of obtaining some documents from small- and medium-sized businesses and farms. These difficulties and costs could result in some deviations from an institution's own loan documentation policy for small- and medium-sized business and farm lending. Such deviations are frequently based on past experience with the customer. In such cases, the loan will not be criticized if the examiner concurs that sufficient information exists to serve as a basis for an informed credit decision.

Implementation

This policy statement will take effect immediately upon issuance. However, the agencies will monitor how qualifying institutions implement its provisions and how those institutions and the loans they designate for inclusion in the exempt basket perform. Changes to this policy statement may be made based on the agencies' experience.

Distribution: FDIC-supervised banks (Commercial and Savings)

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

July 30, 1993

The Honorable John J LaFalce
Chairman
Committee on Small Business
U S House of Representatives
2361 Rayburn House Office Building
Washington, D C 20515-6315

Dear Mr Chairman

Enclosed are responses to follow-up questions from the Committee's hearing on credit availability for small businesses If I can be of any further assistance, please do not hesitate to contact me

Sincerely,

Eugene A Ludwig
Comptroller of the Currency

FOLLOW-UP QUESTIONS
HEARING ON CREDIT AVAILABILITY

Additional Questions for Regulators

1. Giving the Administration full credit for undertaking regulatory and administrative changes in their attempt to relieve the credit crunch, I'm sure you are also aware of the stimulative effect to small business lending that would undoubtedly result from interstate branching--specifically, allowing multi-state bank holding companies, at a minimum, to consolidate their operations into a single bank with multiple branches in several states, and thereby free up capital that would provide the base for additional lending.

   o What kind of prospects do you see for interstate branching legislation in the near term, or medium term?

   o Do you expect an interstate bill to ultimately be attached to some form of regulatory relief legislation, or alternatively, to community development bank legislation, or perhaps, to a package of both?

   o What are the prospects for getting interstate legislation without imposing some of the restrictions demanded by independent insurance agents and the independent bankers that would diminish the stimulative effects of the legislation?

A: The prospects for enactment of interstate branching legislation are difficult to gauge. As we all know, interstate branching is an historically contentious issue that has been debated among several competing interests. I am not in a position to predict the likelihood that such legislation would be attached to other proposals to reduce regulatory burden or to establish community development banks.

Questions for Witnesses from U S Representative Jan Meyers

Q1: On April 24, 1992 the Bush Administration proposed a new Regulatory Uniformity Policy to streamline compliance with banking regulations This proposal instructed your agencies to coordinate examinations, reports and procedures, provide greater flexibility for appraisals, and institute other changes to reduce regulatory burden and overlap Many of these changes are now part of President Clinton's package, what progress have you made in the last year.

A1: The objective of the Regulatory Uniformity Program was to reduce regulatory burden by increasing coordination among the federal regulators of banks and thrifts Under the program, the federal banking agencies agreed to work toward greater uniformity in examinations, applications, Call Reports, and statutory implementation. The credit availability program, which President Clinton announced on March 10, also addresses interagency uniformity, while focusing on improving credit availability, especially to small- and medium-sized businesses and farms

Under the Regulatory Uniformity Program, we have made a number of significant changes to make our policies and regulations more consistent The agencies are limiting the number of revisions to the Call Report to one per year, improving coordination between examiners and external auditors, improving interagency coordination in issuing significant interpretations of statutes, and working to reduce any unnecessary paperwork burden required of banks seeking to comply with the Community Reinvestment Act (CRA). The agencies are also working together to ensure that our examiners are trained consistently. We have begun a major program in the area of credit analysis training

In addition, as announced on June 10, the four federal regulators of banks and thrifts have issued interagency guidelines to coordinate examinations of insured depository institutions and inspections of their holding companies The objective is to minimize disruption and avoid duplicative examination efforts and information requests whenever possible While the guidelines were initially conceived under the Regulatory Uniformity Program, addressing the burden of duplicative examinations was also part of the President's program

Providing greater flexibility for appraisals was not part of the Regulatory Uniformity Project as initially conceived The President's program addressed the burden of inflexible appraisal requirements As a result, the agencies have worked together to improve the effectiveness of their appraisal regulations, and we have assessed problems that bankers have identified with the regulations and monitored the associated regulatory burden On June 4, the agencies issued a joint proposal

to modify our appraisal rules.

We are continuing to carry out other projects to increase consistency among the agencies. For example, the agencies are close to completing an interagency core report of examination that will standardize the reports banks receive at the end of an examination in several areas of examination. We are also working to develop common application forms for use in certain corporate filings

Q2: Are you familiar with the "Credit Availability and Regulatory Relief Act of 1992" which was introduced last year? If so what is your agency's position on that legislation or similar legislation which may be introduced in this Congress?

A2: The Office of the Comptroller of the Currency (OCC) supports efforts to simplify regulatory requirements, make prudent reductions in regulatory burden, and improve credit availability. Before pursuing legislation such as the Credit Availability and Regulatory Burden Relief Act of 1992, however, we believe it is important to focus on what can be accomplished through regulatory and administrative initiatives.

The regulatory and administrative changes under the President's program to improve credit availability would accomplish several of the reforms that the Credit Availability and Regulatory Burden Relief Act seeks to accomplish statutorily. The program aims to simplify regulatory requirements, eliminate unnecessary regulatory burdens, and improve credit availability, particularly to small- and medium-sized businesses and farms and to low-income and minority borrowers and communities. The OCC is committed to carrying out the President's goals The agency is currently directing its efforts to implementing the President's regulatory program and monitoring the results. If necessary, we will follow up this effort with an evaluation of statutory mandates that restrict credit availability and impose unnecessary regulatory burden. We are not in a position at this time to recommend specific statutory changes.

Q3: Many small business loans are made with real estate as collateral which has proved a problem within the regulatory framework. The President's proposals include a relaxation of appraisal requirements on such collateral except when necessary for safety and soundness purposes Can you tell me when these safety criteria would be invoked? Would it be by guidelines or at regulator's discretion?

A3: On June 4, the OCC, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS) issued a joint notice of proposed rulemaking designed to reduce the regulatory burden

associated with real estate appraisals. The proposal would increase, from $100,000 to $250,000, the minimum size of real estate loans for which banks and other insured depository institutions would be required to obtain appraisals by state-licensed or certified appraisers. The proposal would also expand and clarify existing exemptions to appraisal requirements, and identify additional circumstances in which appraisals by licensed or certified appraisers would not be required.

Based on their experience in supervising the appraisal practices of banks and thrifts, the agencies recognize that numerical thresholds cannot identify all transactions for which the services of a licensed or certified appraiser should not be required. The agencies are therefore proposing to retain the right to require an appraisal by a licensed or certified appraiser in specific cases where a real estate loan poses greater than normal risk to the lending institution. For example, an agency may require a problem institution, or an institution in troubled condition, to obtain appraisals for real estate loans below the proposed threshold level. The agencies also propose to retain the right to waive the requirement for an appraisal by a licensed or certified appraiser in specific cases where such appraisals would otherwise be required, if the agency determines that those services are not necessary to protect the safety and soundness of the institution or other public policy interests. Because, in either case, the action taken would be guided by the particular circumstances of the individual institution, the agencies propose to exercise this authority on a case-by-case basis, rather than through generally applicable guidelines.

Q4: I noted in a recent *Wall Street Journal* article that many bankers are afraid to complain about what they consider to be arbitrary actions by regulators because they fear retaliation. What are your agencies doing to address these concerns?

A4: Disagreements between banks and bank supervisors are a normal part of the supervisory process. We do not want bankers to feel they cannot dispute a regulatory action out of fear of retaliation.

We are taking a number of steps to ensure that disagreements are resolved fairly, quickly, and without fear of reprisal. We continue to encourage bankers and examiners to attempt to resolve disagreements through informal discussion, but we recognize that informal discussion can not resolve every dispute. We therefore encourage banks to seek a review of any agency decision or action they believe is incorrect. We have revised our examination appeals process and adopted strict time limits for the resolution of appeals. The OCC has created an ombudsman position to manage the revised appeals process.

Q5: In Mr Hove's testimony he cites $500 billion of potential lending in the banking community right now. There is certainly no shortage of demand for this lending, but I can't believe that lenders' reticence stems from having burned fingers from bad lending in real estate. How much of this has really been driven by past mistakes and how much by regulation?

A5: Some of the decline in bank lending reflects tighter lending standards, not only for real estate loans, but for other types of loans as well. This was a natural response to the credit underwriting excesses of the 1980s. One measure of the deterioration in credit quality is the ratio of the provision for loan and lease losses to total loans, which climbed from 0.77 percent in 1982 to 1.66 percent in 1991, before falling to 1.32 percent in 1992.

High loss rates have understandably made banks more cautious about making loans. Bank managers have increased their emphasis on detailed financial data in assessing the creditworthiness of borrowers and the adequacy of loan collateral. There has also been a decline in the availability of credit from troubled banks that are seeking to work out historically high levels of bad loans and rebuild their capital. In addition, recent changes in bank lending laws and supervisory practices, motivated in large part by the desire to reduce the risk of loss to the federal deposit insurance system, may have increased the cost of lending and contributed to an atmosphere in which bankers--often for good reasons--are more cautious about making loans.

It is difficult to tell how much of the restriction in bank credit resulted from banks' response to past credit problems, and how much from the response of legislators and regulators. In either case, the President's credit availability program, which the OCC, the FDIC, the FRB, and the OTS are jointly carrying out, will help to alleviate this part of the problem. As my testimony described, the program takes a number of administrative steps to reduce the burden of regulations, and to ensure that bankers are not discouraged from extending loans to creditworthy borrowers.

On June 10, the four federal regulators of banks and thrifts announced seven new actions under the President's program. The actions:

- o Make it clear that real estate loans that depend on collateral for repayment need not be reported as foreclosed unless the lender has actually taken possession of the collateral.

- o Make it easier for banks to return restructured nonaccrual loans to accrual status.

- Eliminate certain requirements for minimum down payments on sales of foreclosed real estate

- Reaffirm that it is not regulatory policy to value the collateral underlying real estate loans on a liquidation basis.

- Avoid the improper use of the "Special Mention" loan category, which may have inhibited lending to small businesses.

- Achieve better interagency coordination of bank, thrift, and holding company examinations

- Enhance our ability to detect lending discrimination, improve the level of education we provide to the banking industry and to examiners, and strengthen enforcement of fair lending laws

These latest changes follow a number of actions the four agencies have taken over the last three months to implement the President's credit availability program:

- On March 30, the agencies adopted a new policy to reduce documentation requirements for loans to small- and medium-sized businesses and farms. The OCC prepared specific guidance to examiners regarding those changes.

- On May 27, the agencies sent a letter to all banks and thrifts reiterating the agencies' commitment to effective enforcement of fair lending laws The letter urged the institutions to increase their activities to promote fair lending

- On June 4, the agencies published in the *Federal Register* a joint notice of proposed rulemaking to amend the appraisal regulations we adopted to carry out Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) The proposed amendments would reduce the number of real estate-related financial transactions that require the services of an appraiser and simplify the preparation of appraisals for federally related transactions The amendments are designed to reduce the regulatory burden associated with real estate appraisals while maintaining safety and soundness

The banking agencies will also continue their efforts to reduce paperwork and regulatory burdens and improve the ability of small businesses and consumers to gain access to credit For example, in the coming months, the agencies expect to modify their procedures for corporate applications (e.g., applications for charters, mergers, and branches) to make them less duplicative and more uniform

Q6: I would like to know the pattern of small business lending in the commercial banking industry Can you provide small business loan figures for some of the nation's largest lenders and some of its smallest lenders? For example could you provide me with a breakdown of the small business lending of the 50 largest lending institutions. In such a list could you also provide

a) the amount of their small business lending for the last 5 years which was provided using an SBA 7(a) guarantee or other federal guarantee

b) the amount of their small business lending for the last 5 years which was made without a federal guarantee

Could I have a similar list of figures for small business lending by the 50 leading small lending institutions?

A6: Under existing reporting requirements, commercial banks do not regularly report small business lending information to regulators Moreover, it would be very difficult to gather historical information for specific banks (e.g., the 50 largest institutions) since most banks' systems are not designed to separately capture small business lending data

Beginning with the June 30, 1993 Call Report, however, banks will be required to report annually the number and dollar amount of outstanding business loans with "original amounts" of $1,000,000 or less and farm loans with "original amounts" of $500,000 or less Loan size reflects borrower size, and those data will help us estimate the volume of lending to small businesses and small farms In addition, consistent with the requirements of section 477 of the Federal Deposit Insurance Corporation Improvement Act of 1991, the Federal Reserve Board is expected to collect and publish, on an annual basis, information on the availability of credit to small businesses Going forward, these new data should provide a better basis for analyzing the availability of credit to small businesses

Response to a Question by
The Honorable John J. LaFalce

Q. Giving the Administration full credit for undertaking regulatory and administrative changes in their attempt to relieve the credit crunch, I'm sure you are aware of the stimulative effect to small business lending that would undoubtedly result from interstate branching - specifically, allowing multi-state bank holding companies, at a minimum, to consolidate their operations into a single bank with multiple branches in several states, and thereby free up capital that would provide the base for additional lending.

- **What kind of prospects do you see for interstate branching legislation in the near term, or medium term?**
- **Do you expect an interstate bill to ultimately be attached to some form of regulatory relief legislation, or alternatively, to community development bank legislation, or perhaps, to a package of both?**
- **What are the prospects for getting interstate legislation without imposing some of the restrictions demanded by the independent insurance agents and the independent bankers that would diminish the stimulative effect of the legislation?**

A. It is hard to predict what Congress will consider, in terms of banking issues, this year. Clearly, the most significant banking issue facing Congress to date has been the RTC's and SAIF's funding needs. This measure is expected to be considered by the House prior to the July 4th recess.

It is not clear what the Banking Committees will take up, if anything, after they have resolved the RTC/SAIF funding issue. However, interstate branching legislation may become a priority in light of Rep. Neal's (D-NC) chairmanship of the House Banking Subcommittee on Financial Institutions. Rep. Neal has been a key advocate of interstate branching legislation. In any event, one would certainly expect Congress to re-focus on this issue in the long-term.

Likewise, it is difficult to predict -- at this time -- whether an interstate branching bill will be attached to other banking related legislation. It is certainly probable that such "powers" related legislation could be attached to consumer-oriented legislation like a community development banks program.

Finally, we would expect that attempts to pass interstate branching legislation would face the same battles as in the past from the insurance industry. Unless these two industries can reach an acceptable compromise, it is probably unlikely that interstate branching legislation could be passed by Congress.

###

**FDIC Responses to Follow-up Questions
from U.S. Rep. Jan Meyers**

**Hearing on Credit Availability
Committee on Small Business
April 29, 1993**

Q.1. **On April 24, 1992 the Bush Administration proposed a new regulatory uniformity policy to streamline compliance with banking regulations. This proposal instructed your agencies to coordinate examinations, reports and procedures, provide greater flexibility for appraisals, and institute other changes to reduce regulatory burden and overlap. Many of these changes are now part of President Clinton's package, what progress have you made in the last year?**

A.1. The Regulatory Uniformity Project (RUP) committed the Federal banking agencies to a policy of promoting regulatory consistency, removing duplicative or outmoded policies, procedures and regulations, and improving coordination with appropriate state authorities.

Considerable progress has been made on a number of the projects initiated under the RUP program. Projects that have already been completed include: (a) an agreement between the Federal Deposit Insurance Corporation (FDIC) and Conference of State Bank Supervisors specifying how examination responsibilities would be shared between the FDIC and state banking authorities; (b) an agreement among the Federal banking agencies to announce revisions to the quarterly Call Reports prior to the start of the calendar year in which the revisions take effect; (c) a policy statement adopted by the agencies to improve coordination and communication between external auditors and bank examiners; (d) a review of CRA paperwork burdens with recommendations for reducing that burden; and (e) a system for coordinating agency interpretations of statutes.

Several projects initiated under the RUP program and subsequently incorporated into the March 10 interagency policy statement on credit availability are nearing completion. These include: (a) an interagency agreement to coordinate examinations of depository institutions and their holding companies; (b) a common core examination report with uniform procedures (report currently is being field tested); (c) common definitions on "special mention" assets as well as consistent standards for classification and valuation of assets; (d) consistency in accounting for partially charged-off loans and collateral dependent loans, and in the analysis of the allowance for loans and lease losses; (e) common examiner training courses that focus on report

preparation and loan analysis (several successful pilot training classes already have been conducted); and (f) common application forms for change of control, change of management in troubled institutions, and mergers.

In connection with the interagency credit availability program, the agencies issued a policy statement on loan documentation for small- and medium-sized business and farm loans on March 30 and, more recently, issued a proposal for public comment on modifications to current appraisal regulations, on May 26.

Q.2. **Are you familiar with "The Credit Availability and Regulatory Relief Act of 1992" which was introduced last year? If so, what is your agency's position on that legislation or similar legislation which may be introduced in this Congress?**

A.2. The "Credit Availability and Regulatory Relief Act of 1992" is similar to the "Depository Institution Burden Relief Act of 1993," which was introduced on January 5, 1993 by Representative Bereuter. The FDIC has no official position on this bill. However, some general observations follow.

Although we agree with the purpose of the bill, that is, to reduce some of the regulatory burden imposed on financial institutions, and could support many of its provisions, we are not convinced that other provisions are necessary or represent the best possible approaches to reducing regulatory burden. For example, the following provisions appear to have merit: reducing or eliminating the burden of Section 132 of the FDIC Improvement Act of 1992 (FDICIA) regarding safety and soundness standards; easing the burden of data collection not needed for safety and soundness purposes; and reducing the impact of the FDICIA branch closing notice requirements. On the other hand, the bill's "capital-efficient" institution concept may create new administrative burdens for the banking agencies and appears to add little to what we can already do with our general safety and soundness authorities.

Q.3. **Many small business loans are made with real estate as collateral which has proved a problem within the regulatory framework. The President's proposals include a relaxation of appraisal requirements on such collateral except when necessary for safety and soundness purposes. Can you tell me when these safety criteria would be invoked? Would it be by guidelines or at regulator's discretion?**

A.3. The FDIC worked with the other Federal banking agencies to add a new business loan exemption to the appraisal regulations. This exemption is included in the joint proposal on appraisals, released on May 26. The proposed exemption would apply only to transactions with a value of less than

$1 million where the sale of, or rental income derived from, the real estate taken as collateral is not the primary source of repayment. This would help to ensure that the transactions involve small- and medium-sized businesses and that any losses associated with exempting these transactions would not generally pose a threat to the safety and soundness of financial institutions. Any undue concentration in loans using this exemption that affects the risk profile of an individual institution will be addressed through examinations and other normal supervisory processes.

Q.4. I noted in a recent <u>Wall Street Journal</u> article that many bankers are afraid to complain about what they consider to be arbitrary actions by regulators because they fear retaliation. What are your agencies doing to address these concerns?

A.4. The FDIC instituted an appeals process for bankers in early 1992. This appeals process provides bankers with an avenue to obtain review of an examiner's decision. In addition, we encourage bankers to deal openly and candidly with us on the merits of any supervisory issue so that each side understands the factual and analytical basis for any differing positions.

The interagency credit availability program directs the Federal banking agencies to have appeals processes which are "fair and effective." The interagency program also directs the agencies to ensure that there is no retribution against either the bank or the examiner as the result of an appeal.

Retaliation for questioning a supervisory decision will not be tolerated by the FDIC. If a banker were to allege retaliatory action of an arbitrary nature on the part of any FDIC examiner or supervisory official, we would promptly investigate and, if warranted, take appropriate disciplinary action against the examiner or supervisory official involved. To date, we are unaware of any instances where a banker has complained about retaliation as the result of engaging in an appeal. However, the FDIC on rare occasion has received complaints about retaliation with regard to bankers ongoing relationships with examiners. These complaints are looked into immediately and appropriate action is taken.

Regulators are like everyone else, they are not always "right" on every one of the numerous issues that normally arise during the course of an examination and the supervisory process. We depend on bankers for relevant information and critical testing of our initial findings and conclusions. Their cooperation in this process is essential to reaching sound and fair final decisions on supervisory issues. Consequently, maintaining an open and frank dialogue with bankers free of any constraining fears is a very important goal for us.

Q.5. In Mr. Hove's testimony, he cites $500 billion of potential lending in the banking community right now. There is certainly no shortage of demand for this lending, but I can't believe that bankers' reticence stems from having burned fingers from bad lending in real estate. How much of this has really been driven by past mistakes and how much by regulation?

A.5. There is no way of knowing how much bankers' reticence to lend has been driven by past mistakes or how much by regulation. Of course, other factors have curbed lending too. We believe that the predominant factor explaining the current pace of lending is slack loan demand resulting from the 1990-91 recession and slow recovery in our economy, with considerable uncertainties remaining about future business conditions and prospects. As indicated in our testimony, many borrowers are not drawing down credit lines they negotiated with their banks and for which they paid fees. These credit lines represent legally committed funds for businesses and are unaffected by any past lending mistakes or regulatory constraints. The failure of borrowers to draw down these lines suggest that they have no immediate need for the additional funds based on their assessment of immediate and future business conditions.

Q.6. I would like to know the pattern of small business lending in the commercial banking industry. Can you provide small business loan figures for some of the nation's largest lenders and some of its smallest lenders? For example, could you provide me with a breakdown of the small business lending of the 50 largest lending institutions. In such a list could you also provide:

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Could I have a similar list of figures for small business lending by the 50 leading small lending institutions?

A.6. Data are not currently available on the small business loan segment of commercial loans made by the commercial banking industry. However, annual reporting requirements for insured banks, thrifts, and U.S. branches of foreign banks on loans to small businesses (and to small farms) were approved by the Federal Financial Institutions Examination Council (FFIEC) in October 1992 and will take effect on June 30, 1993. These annual reporting requirements will implement Section 122 of FDICIA.

For purposes of these new reporting requirements, "loans to small businesses" are defined as "loans secured by nonfarm nonresidential properties" and "commercial and industrial loans" with original amounts of $1 million or less. In general, commercial banks will report the number and amount currently outstanding as of June 30 of nonfarm nonresidential real estate loans and of commercial loans with original amounts of $100,000 or less; more than $100,000 through $250,000; and more than $250,000 through $1,000,000.

Information on the volume of commercial bank lending under the Small Business Administration's (SBA) 7(a) guarantee program, on an overall basis and for individual institutions, may be available from the SBA.

Q.7. Giving the Administration full credit for undertaking regulatory and administrative changes in their attempt to relieve the credit crunch, I'm sure you are aware of the stimulative effect to small business lending that would undoubtedly result from interstate branching - specifically, allowing multi-state bank holding companies, at a minimum, to consolidate their operations into a single bank with multiple branches in several states, and thereby free up capital that would provide the base for additional lending.

- **What kind of prospects do you see for interstate branching legislation in the near term, or medium term?**
- **Do you expect an interstate bill to ultimately be attached to some form of regulatory relief legislation, or alternatively, to community development bank legislation, or perhaps, to a package of both?**
- **What are the prospects for getting interstate legislation without imposing some of the restrictions demanded by the independent insurance agents and the independent bankers that would diminish the stimulative effect of the legislation?**

A.7. It is hard to predict what Congress will consider, in terms of banking issues, this year. Clearly, the most significant banking issue facing Congress to date has been the RTC's and SAIF's funding needs. This measure is expected to be considered by the House prior to the July 4th recess.

It is not clear what the Banking Committees will take up, if anything, after they have resolved the RTC/SAIF funding issue. However, interstate branching legislation may become a priority in light of Rep. Neal's (D-NC) chairmanship of the House Banking Subcommittee on Financial Institutions. Rep. Neal has been a key advocate of interstate branching legislation. In any event, one would certainly expect Congress to re-focus on this issue in the long-term.

Likewise, it is difficult to predict -- at this time -- whether an interstate branching bill will be attached to other banking related legislation. It is certainly probable that such "powers" related legislation could be attached to consumer-oriented legislation like a community development banks program.

Finally, we would expect that attempts to pass interstate branching legislation would face the same battles as in the past from the insurance industry. Unless these two industries can reach an acceptable compromise, it is probably unlikely that interstate branching legislation could be passed by Congress.

Office of Thrift Supervision
Department of the Treasury
Director
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

July 2, 1993

The Honorable Jan Meyers
Committee on Small Business
U.S. House of Representatives
Washington, D.C. 20515

Dear Congresswoman Meyers:

I have enclosed responses to your follow-up questions submitted in conjunction with the April 29, 1993 hearing on credit availability.

If I may be of further assistance, please do not hesitate to contact me.

Sincerely,

Jonathan L. Fiechter
Acting Director

Enclosure

OTS Responses to Questions Concerning Credit Availability

1. On April 24, 1992, the Bush Administration proposed a new regulatory uniformity policy to streamline compliance with banking regulation. This proposal instructed your agencies to coordinate examinations, reports and procedures, provide greater flexibility for appraisals, and institute other changes to reduce regulatory burden and overlap. Many of these changes are now part of President Clinton's package. What progress have you made in the last year?

The four Federal bank and thrift regulatory agencies have worked together since April 1992 on a Regulatory Uniformity Project. Several of these projects, as well as some new enhancements, have continued as part of the Clinton Administration's Credit Availability Program. The initiatives have been monitored by interagency steering groups composed of senior level personnel. The following describes the most important accomplishments to date.

o <u>Examinations</u>

The OTS and the FDIC entered into a memorandum of understanding on May 18, 1992, designed to promote the most efficient use of FDIC and OTS resources. The memorandum clarified the roles of the OTS and the FDIC, established communication responsibilities and a process for resolving material differences in examination findings. We feel that the process is working.

The four agencies also are developing a common format for the Report of Examination. As part of this initiative, the OTS is converting from its MACRO rating system to the banking agencies' CAMEL rating system. All the agencies are committed to adopting a common format for examinations beginning in the third quarter of 1993.

o <u>Appraisals</u>

On April 13, 1992, OTS published a final rule on Appraisals that was the result of interagency coordination to increase both regulatory flexibility and uniformity among the agencies' policies. OTS identified additional transactions for which the services of an appraiser are not required, and increased from $50,000 to $100,000 the threshold level at or below which appraisals are not required.

On June 1, 1993 the OTS, in conjunction with the other Federal bank regulatory agencies, forwarded to the Federal Register a joint notice of proposed rulemaking that would increase to $250,000 the threshold level at or below which appraisals are not required, expand and clarify existing exemptions to the appraisal requirement, and identify additional circumstances when appraisals are not required.

- Valuation Allowances

Another initiative under the Regulatory Uniformity Project was the development of interagency guidance on valuation allowances. Valuation allowances are used by institutions to recognize estimated losses or exposure inherent in their portfolios. The goal of this project was to devise qualitative and quantitative guidance for both institutions and examiners to use to assess the adequacy of valuation allowances. Earlier this month, the agencies reached agreement on the structure and content of this guidance, which we hope to issue shortly as a joint policy statement. A key element will be numeric guidance on appropriate allowance levels for adversely classified assets and the rest of thrifts' and banks' portfolios.

2. Are you familiar with "The Credit Availability and Regulatory Relief Act of 1992" which was introduced last year? If so, what is your agency's position on that legislation or similar legislation which may be introduced in this Congress?

The OTS has reviewed many of the regulatory burden relief bills that have been introduced in this Congress as well as the Credit Availability and Regulatory Relief Act of 1992. We support the objectives of ensuring that the regulatory and statutory environment does not adversely affect the availability of credit to sound borrowers. However, a major source of regulatory burden is the frequency with which the rules governing the thrift industry have changed in recent years. As you know, Congress has in recent years enacted a series of major banking statutes having a substantial impact on thrifts. One consequence of that has been that thrifts have been unable to predict with reasonable certainty what rules will apply to them one or two years down the road. We would urge prudence upon Congress as it considers legislation that could revise the laws that govern thrifts and banks.

The OTS is committed to working closely with other parts of the Administration, the independent bank regulatory agencies and the Congress to develop a coherent, long-term strategy for dealing with the very real concerns of depository institutions. Our first priority, however, has been to attempt to remove some of the current uncertainty for financial institutions by implementing the recent laws that are already on the books, and reviewing and, where possible, improving the rules already in place.

3. Many small business loans are made with real estate as collateral which has proved a problem within the regulatory framework. The president's proposals include a relaxation of appraisal requirements on such collateral except when necessary for safety and soundness purposes. Can you tell me when these safety criteria would be involved? Would it be by guidelines or at regulator's discretion?

On June 4, 1993, the four Federal bank and thrift regulatory agencies issued a joint proposed regulation to amend our current appraisal rules to reduce regulatory burden while continuing to require appraisals when necessary for safety and soundness reasons. The proposal would revise our treatment of business loans that are of a small dollar amount (e.g., less than $1 million) and where repayment of the loan is not dependent on the sale of, or rental income derived from, the real estate taken as collateral. Under the proposal, such business loans will no longer be required to have a formal appraisal; rather, a more informal evaluation of the real estate collateral would suffice.

4. I noted in a recent Wall Street Journal article that many bankers are afraid to complain about what they consider to be arbitrary actions by regulators because they fear retaliation. What are your agencies doing to address these concerns?

OTS regards any form of retaliation as unprofessional, unacceptable, and unethical conduct by an examiner or any other OTS employee. Any such conduct would subject an employee to disciplinary action and possible dismissal.

Each OTS employee is prohibited from engaging in conduct that is prejudicial to the government (5 C.F.R. section 735.203) and has a basic obligation to "act impartially" and avoid any actions creating the appearance that they are violating the law or any ethical standard (5 C.F.R. section 2635.101). Each OTS employee, in Washington, D.C., and all five regional offices, attended our recent "Standards of Ethical Conduct" training sessions where all forms of proper conduct were reviewed and discussed.

On April 6, 1992, we initiated a Supervisory Review Process (SRP) as a means to review examination disagreements at the Washington level. To date we have received only nine appeals under the SRP.

Pursuant to the President's credit availability initiatives, we are conducting a complete review of our existing SRP and are considering some modifications to enhance that process as well as initiate new procedures at both the regional and national level to improve the consistency and quality of examination reports, and conformance with national standards. The following initiatives are being finalized for implementation this summer:

o Improve national communications to field staff.

Many of the industry concerns relate to the complaint that examiners are not using the most recent examination policies and procedures. We will improve national communications of examination and policy changes to the examination staff by using the internal electronic mail system to go directly to each examiner. This will produce better quality examinations which should result in fewer situations where there are industry concerns about differences in the implementation of national policy.

o <u>Improve communications between examiners and management.</u>

We are establishing a senior position in each region to review final reports of examination for content, perspective, and conformance with current national policy guidelines.

This person will also conduct regular on-site institution visits to interview management and solicit comments regarding the quality and efficiency of the examination, and policy issues for OTS consideration. This interview will allow institutions to voice their concerns in a less formal environment with direct input to the regional office. We are hopeful that institutions will be more willing to discuss differences at this level.

We will also require the examiner-in-charge of each exam to discuss with management the entire process to resolve examination differences. This will include discussion of differences during the examination, and then at the regional office level, and finally through the SRP.

o <u>Supervisory Review Process</u>

The existing program for Washington based review of examination disagreements will be retained. We will provide the industry with better information on the program and our decisions in order to encourage its use by the industry.

5. In Mr. Hove's testimony he cites $500 billion of potential lending in the banking community right now. There is certainly no shortage of demand for this lending, but I can't believe that bankers' reticence stems from having burned fingers from bad lending in real estate. How much of this has really been driven by past mistakes and how much by regulation?

The lack of willingness by banks and thrifts to lend is due to a wide variety of factors, including:

- general trends in the economy,
- a desire by both borrowers and lenders to improve their balance sheets,
- the adoption of more rigorous underwriting standards after the losses associated with some practices in the 1980s,
- the attractiveness of other types of investments,
- the effect of higher capital requirements, supervisory policies, and examination practices, and
- the increase in regulation mandated by recently enacted laws.

While we cannot quantify the effect on current lending decisions of any of these factors, including past losses or current regulatory burden, we have an affirmative responsibility to ensure that we avoid inappropriate policies and practices that exacerbate any reluctance to lend to creditworthy borrowers. Toward that end, we have undertaken several initiatives -- the "Credit Availability Initiatives" -- to address concerns raised about some of our policies by bankers. These initiatives include those related to loan documentation requirements, revisions to our appraisal regulations, certain accounting requirements, and actions in several other areas.

6. I would like to know the pattern of small business lending in the commercial banking industry. Can you provide small business loan figures for some of the nation's largest lenders and some of it's smallest lenders? For example could you provide me with a breakdown of the small business lending of the 50 largest lending institutions. In such a list could you also provide:

a) the amount of their small business lending for the last 5 years which was provided using an SBA 7(A) guarantee or other federal guarantee;

b) the amount of their small business lending for the last 5 years which was made without a federal guarantee.

7. Could I have a similar list of figures for small business lending by the 50 leading small lending institutions?

The OTS does not currently collect such data. Section 205 of FDICIA requires that the Federal Reserve Board collect and publish, on an annual basis, information on the availability of credit to small businesses. Therefore, in June 1993 the OTS will begin to collect a new Thrift Financial Report Schedule that will contain information on small business lending.

Thrift institutions have traditionally been home mortgage lenders and their commercial loan portfolios are quite small. By statute, Federal savings associations are limited in their authority to make commercial loans to 10% of assets. As of December 31, 1992, the total amount of outstanding commercial loans reported by thrifts was less than $7 billion, less than 1% of their total assets.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

To: All OCC Examining Staff

From: Eugene A. Ludwig

Date: April 28, 1993

Re: Implementation of the President's Credit Availability Program

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As your new Comptroller I want to share with you several recent observations about our examination process as it relates to President Clinton's recently announced program to help stimulate lending, particularly small- and medium-sized business lending.

I hope that you will review this memorandum and attached material with particular care. It relates to an issue of national importance in which both you and I play a critical role.

Over the last several years, the OCC examination staff has faced up to as tough a challenge as has been undertaken by bank supervisors in this century. As a result of OCC efforts, pushed forward in a period of adversity, the banking industry happily did not go the way of the S&L industry. That job, largely accomplished, is a credit to the OCC's fine examination teams.

As confident as I am that the OCC examination staff has done a fine job fulfilling its mission over the past several years, I am also convinced that:

> we are now entering a new period where the challenges are quite different from the period we have just been through;
>
> at this point in time, credit availability, particularly to small- and medium-sized businesses, is one of the critical elements in a strong economic recovery, a recovery that includes meaningful job growth;
>
> credit availability has been impeded by certain rules, regulations, and processes that have been overly restrictive; and

> such overly restrictive rules, regulations and processes can be changed <u>without sacrificing safety and soundness</u>

The President's program -- announced on March 10th in a speech attended by members of Congress and the heads of the federal bank and thrift supervisory agencies, and in a joint statement by the federal bank and thrift regulatory agencies, a copy of which I enclose -- strikes this balance between credit availability and safety and soundness.

Importantly, the President's new program seeks to strike this balance by principally doing three things.

> First, the program targets for change specific rules and regulations that are overly burdensome. These changed rules and regulations will be published over the next several months. And, of course, as these rules and regulations are changed, copies will be immediately provided to you.
>
> Second, the program asks the supervisory agencies to identify new areas of activity for banks and thrifts that pose risks that ought to be regulated more carefully. Here too, as rules and regulations are written to deal with these issues, we will of course get them to you.
>
> Third, the President's program identifies certain ways in which the examination process itself can be effective, while at the same time less burdensome. For example, the program will eliminate duplication of examinations by multiple agencies, except where such duplication is explicitly required by law

However, regardless of how well crafted this program may be, the key to making this program work, the key to a stronger economy and sounder banks, is you the examiner. The rules and regulations which we redraft are only fully effective if you the examiner implement them both carefully and correctly and in the spirit of the President's program.

Furthermore, beyond the specific rule changes effected by the President's program is the all-important area of examiner judgment which is so central to bank and thrift examinations

I know our examiners are extremely capable individuals with very good judgment. However, I am also well aware that the events of the past several years have conspired, in essence, to pressure examiners into being overly restrictive in some instances. And, this restrictiveness has in a number of cases caused banks to pull back from lending, even in cases where the potential borrower may have been creditworthy

As things have stood, it has been too easy for bankers and examiners alike to fall into the trap of substituting rigid procedures and reviews for good judgment in assessing the risk and strength of loans. A fundamental goal of the President's program on credit availability is to free both

bankers and examiners from this trap The program is intended to give you the freedom to do what you do best -- use your experience and good judgment

Banks cannot and should not be forced to eliminate all risk from their balance sheets The President in announcing his program recognized the consequences of attempting to establish a risk-free banking system -- a system with anemic credit availability which in the end actually leads to less safety and soundness in the banking system The President also recognized the importance of the examination function in achieving safety and soundness and credit availability through helping bankers to properly manage risk.

Finally, I have confidence you will assist me in making this program work In this regard, I want to make clear to you that I take full responsibility for the changes that are being effected by this program If there is criticism of the program, it is my job to bear the brunt of this criticism I stand behind this program, because I firmly believe that it is the right thing to do and that it will result not merely in greater credit availability for our economy, but also in a safer and sounder banking system

If you have any questions or suggestions about this effort, please send them directly to me

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